89-1502 (1)

Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

AMERICAN STOCK EXCHANGE, INC., CHICAGO BOARD OPTIONS EXCHANGE, INCORPORATED, and THE OPTIONS CLEARING CORPORATION,

Petitioners,

v.

CHICAGO MERCANTILE EXCHANGE, BOARD OF TRADE OF THE CITY OF CHICAGO, PHILADELPHIA STOCK EXCHANGE, INC., and SECURITIES AND EXCHANGE COMMISSION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT (SEVENTH CIRCUIT NOS. 89-1763 and 89-1786)

BURTON R. RISSMAN,
Counsel of Record
ROGER PASCAL
WILLIAM H. NAVIN
Schiff Hardin & Waite
7200 Sears Tower
Chicago, Illinois 60606
(312) 876-1000
Attorneys for The Options Clearing Corporation

Of Counsel

DON L. HORWITZ
General Counsel
The Options Clearing Corporation

MAHLON M. FRANKHAUSER
Lord Day & Lord,
Barrett Smith
1201 Pennsylvania Avenue, N.W.
Suite 821
Washington, D.C. 20004
(202) 393-5024
Attorney for American Stock Exchange, Inc.

NANCY R. CROSSMAN
Chicago Board Options Exchange, Incorporated
LaSalle at Van Buren
Chicago, Illinois 60605
(312) 786-5600
Attorney for Chicago Board Options Exchange, Incorporated

Attorneys for Petitioners

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QUESTIONS PRESENTED

1. Is a financial instrument that is offered and sold to the public as an investment, traded on national securities exchanges, and cleared and settled in the same manner as other securities, subject to plenary regulation by the Securities and Exchange Commission under the federal securities laws or by the Commodity Futures Trading Commission under the Commodity Exchange Act?

2. What are the meanings of the terms "contract of sale of a commodity for future delivery," "option," and "privilege" for the purpose of allocating jurisdiction over new financial instruments between the Securities and Exchange Commission and the Commodity Futures Trading Commission? Is an expansive interpretation of "futures contract" appropriate and consistent with Congressional intent if the effect is to prevent the application of the federal securities laws to innovative investment instruments?

3. Is a financial instrument that gives the purchaser a perpetual privilege to receive the value of an index of common stocks (or a privilege to acquire the stocks comprising the index) a "privilege on any . . . group or index of securities (including any interest therein or based on the value thereof)" subject to the jurisdiction of the Securities and Exchange Commission under Section 9(g) of the Securities Exchange Act of 1934?

LIST OF PARTIES

The proceedings in the Court of Appeals arose on petitions for review of orders of the Securities and Exchange Commission approving, pursuant to the provisions of the Securities Exchange Act of 1934, as amended, proposed rules changes of the petitioners and of the Philadelphia Stock Exchange, Inc. The parties to the proceedings before the Court of Appeals were as follows: the petitioners were the Chicago Mercantile Exchange, the Board of Trade of the City of Chicago, and the Investment Company Institute; the respondent was the Securities and Exchange Commission; and the intervening respondents were the petitioners herein* and the Philadelphia Stock Exchange, Inc. Although the Commodity Futures Trading Commission was not a party before the Court of Appeals, it filed a brief and presented an oral argument, as *amicus curiae,* on behalf of the positions taken by the Chicago Mercantile Exchange and the Board of Trade of the City of Chicago.

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* Pursuant to Rule 29.1 of the Rules of this Court, petitioners state that they have no parent companies or subsidiaries (other than wholly owned subsidiaries), except that (i) National Securities Clearing Corp., Securities Industry Automation Corp., and The Depository Trust Company are non-wholly-owned subsidiaries of the American Stock Exchange, Inc., and (ii) The Cincinnati Stock Exchange is a non-wholly-owned subsidiary of Chicago Board Options Exchange, Incorporated. The stock of the applicants is not publicly traded. Control of the applicants is vested in their respective members.

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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners, American Stock Exchange, Inc., Chicago Board Options Exchange, Incorporated and The Options Clearing Corporation respectfully request that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered on August 18, 1989, in two companion cases (Nos. 89-1763 and 89-1786).

OPINIONS BELOW

The opinion of the Court of Appeals, which is reproduced in the Appendix beginning at App. 1, is reported at 883 F.2d 537 (7th Cir. 1989). The order of the Securities and Exchange Commission which was the subject of review in No. 89-1763 appears in the Appendix beginning at App. 26 and is published at 54 Fed. Reg. 15,280 (1989). The order of the Securities and Exchange Commission which was the subject of review in No. 89-1786 appears in the Appendix beginning at App. 84 and is published at 54 Fed. Reg. 15,575 (1989). The opinion of the Court of Appeals denying the petitions for rehearing is reported at 883 F.2d 550 (7th Cir. 1989) and is reproduced in the Appendix beginning at App. 108.

JURISDICTION

The judgment of the Court of Appeals was entered on August 18, 1989. The order denying the timely petitions for rehearing in both cases was entered on October 23, 1989. By order entered January 12, 1990, this Court extended the time for the filing by petitioners of a petition for a writ of certiorari to and including March 22, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1) (1988).

STATUTES AND REGULATION INVOLVED

This case involves Sections 3(a)(10), 9(g), 25(a) and 28(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), 15 U.S.C. §§78c(a)(10), 78i(g), 78y(a) and 78bb(a) (1988); Section 2(a)(1) of the Commodity Exchange Act, as amended (the "CEA"), 7 U.S.C. §§2, 2a (1988); and Securities and Exchange Commission Rule 9b-1, 17 C.F.R. §240.9b-1 (1989). The pertinent portions of the texts of these provisions are set forth in the Appendix beginning at App. 112.

STATEMENT OF THE CASE

Petitioners American Stock Exchange, Inc. ("AMEX") and Chicago Board Options Exchange, Incorporated ("CBOE") are registered with the Securities and Exchange Commission ("SEC") as national securities exchanges pursuant to Section 6 of the Exchange Act, 15 U.S.C. §78f (1988). Both exchanges maintain exchange markets for options to purchase and sell underlying common stocks and government securities, as well as options based on the value of underlying stock indexes. AMEX also maintains exchange markets in a wide variety of other types of securities, including common and preferred stocks, warrants, rights, and corporate bonds and debentures.

All of the options which are traded on AMEX and CBOE, as well as the options which are traded on three other national securities exchanges,[1] are issued by petitioner The Options Clearing Corporation ("OCC") and are publicly offered and sold to the public as registered securities under the provisions of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. §§77a-77aa (1988), and Rule 9b-1 under the Exchange Act, 17 C.F.R. §240.9b-1 (1989), which is the options disclosure rule of the SEC. OCC has responsibility for the settlement of all transactions in options which are effected on national securities exchanges, and is registered with the SEC as a securities clearing agency pursuant to the provisions of Section 17A of the Exchange Act, 15 U.S.C. §78q-1 (1988).

Following the break in the securities markets in October, 1987, studies by the SEC's Division of Market Regulation and the New York Stock Exchange, as well as recommendations and testimony by the SEC, suggested that the listing and trading of "baskets" of stocks could help ameliorate the volatility and steep price declines that had been experienced during and after the market break. (App. 67-68). The SEC's staff study also noted that trading in market baskets could provide greater efficiencies than trading in the individual stocks and that this would add an additional layer of liquidity to the stock market to help absorb velocity and concentration of trading. (App. 68). Moreover, it was noted that trading in market baskets would eliminate some of the market information limitations that are present in the trading of the individual stocks. (App. 68-69). It was also believed that market baskets would provide an alternative vehicle for retail investors "to invest in 'the market'." (App. 69).

[1] Securities options are traded on the New York Stock Exchange, the Philadelphia Stock Exchange and the Pacific Stock Exchange as well as on AMEX and CBOE.

The Philadelphia Stock Exchange, Inc. ("PHLX"), AMEX and CBOE, together with OCC, created a new type of market basket instrument, called an "index participation" ("IP"), which was designed to permit retail investors to make investment decisions based on the direction of the market as a whole (App. 69) and to receive the equivalent of the dividend income flowing from a basket of stocks. IPs were designed to trade as market baskets and to furnish the advantages which the studies of the market break had noted would be associated with the trading of market baskets. (*See* App. 70).

The IPs designed by all three exchanges were perpetual instruments which conferred on their holders a present interest in the current value of a specified portfolio (or basket) of stocks comprising an underlying index. (App. 27 and 86). Essentially, the purchaser of every IP acquired two basic rights. First, the purchaser acquired the right to receive a quarterly dividend equivalent equal to the regular cash dividends accrued over the quarter which an owner of the specified portfolio of stocks would be entitled to receive. (App. 27). Second, the purchaser acquired the privilege to receive, upon exercise, an amount of cash based on the value (or a multiple of the value) of the underlying index of securities, and, in the case of the IP designed by the AMEX, the alternative privilege under specified circumstances to receive physical delivery of the shares of stocks comprising the index. These privileges were exercisable on dates specified by the exchange which created the particular IP. The IPs traded on PHLX were exercisable daily,[2] the IPs traded on AMEX were exercisable quarterly, and the IPs traded on

[2] If the purchaser exercised on a fixed quarterly date, he was entitled to receive 100% of the value of the underlying index; if he exercised on any other day, he was entitled to 99.5% of such value. (App. 28).

CBOE were exercisable semi-annually.[3] (App. 87-88). The IPs designed by CBOE also gave the seller the privilege to exit his position by paying the value of the index. This privilege was also exercisable semi-annually. (App. 29-30).

Assuming that the exchanges succeeded in establishing liquid markets for the trading of IPs, the holder of an IP (like the holder of any other security) would have had the ability to sell his IP in the market at any time and to realize a profit or loss in that fashion. The seller of an IP would have had the ability to terminate his obligation at any time by purchasing an offsetting IP in the market.

In many respects, IPs were designed to resemble the standardized options that were traded on the exchanges and issued and cleared by OCC. Thus, IPs were to be treated on the same basis as standardized securities options for purposes of meeting the registration requirements and customer disclosure obligations of the 1933 Act, the Exchange Act, SEC Rule 9b-1, and the exchanges' rules (App. 75-76); fixing customer protections in connection with marketing (App. 78); fixing position and exercise limits (App. 79-80); halting and suspending trading (App. 80); issuance, clearance and settlement (App. 80, 89-93, and 100-02); providing the mechanisms for exercise and allocating exercise notices (App. 30-31 and 89-90); maintenance of clearing house margin (App. 102); and providing for the pledge of the instrument (App. 102-03). The trading rules of the exchanges applicable to options and other securities and the general clear-

[3] The Court of Appeals' statement that IPs "are settled quarterly" on the same dates as futures contracts (App. 17) is simply wrong. Apart from the fact that the IPs designed by PHLX are exercisable more frequently and those by CBOE less frequently, the Court's statement ignores that IPs are perpetual and that "settlement" will never occur unless the purchaser exercises his privilege.

ance and settlement rules of OCC applicable to options were also made applicable to IPs. IPs were thus designed to be traded and cleared in the same manner as options and other securities, and not to be traded and cleared like futures contracts.[4]

In early 1988, the three exchanges and OCC filed with the SEC, as required by Section 19(b) of the Exchange Act, 15 U.S.C. §78s(b) (1988), proposed modifications to their existing rules to provide for IPs. The SEC published notices of the proposals and invited public comments thereon. Respondents Chicago Mercantile Exchange ("CME") and the Board of Trade of the City of Chicago ("CBT"), as well as the Commodity Futures Trading Commission ("CFTC"), filed comments arguing that the SEC lacked jurisdiction to approve the IPs rules of the exchanges and OCC on the ground that IPs were not a "security" within the meaning of the securities laws and in any event were "contracts of sale of a commodity for future delivery" ("futures contracts") and therefore subject to the exclusive jurisdiction of the CFTC under the provisions of the CEA. (App. 37-38 and 85 at n. 7). The SEC also received comments from the Investment Company Institute ("ICI") arguing that IPs were investment company

[4] There are significant differences between the trading and clearance procedures for securities and the procedures applicable to futures. For example, securities exchanges have specialists and market-makers who are obligated, under exchange rules, to help maintain fair and orderly markets. *See, e.g.*, AMEX Rules 170 and 958, CCH American Stock Exchange Guide ¶¶ 9310 and 9758; CBOE Rule 8.7, CCH Chicago Board Options Exchange Guide ¶ 2277; PHLX Rule 1014, CCH Philadelphia Stock Exchange Guide ¶ 3014. Traders on futures exchanges have no obligation to maintain fair and orderly markets. Futures clearing systems permit daily realization of profit and loss through variation margin payments (*see* S. Rep. No. 1131, 93rd Cong., 2d Sess., at 17, *reprinted in* 1974 U.S. Code Cong. & Admin. News 5843, 5857-58. In contrast, securities clearing systems permit realization of profit and loss only when securities are disposed of.

securities subject to the provisions of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. §§80(a)-1 to 80(a)-64 (1988). (App. 37).

On April 11, 1989, the SEC entered orders approving the proposed rules modifications of the three exchanges (Appendix B) and OCC (Appendix C). The SEC determined that IPs were securities[5] and not futures and the trading of IPs was subject to its regulatory jurisdiction (App. 46) and that IPs were not investment company securities subject to the ICA (App. 66). The SEC found that "IPs will provide retail investors with a cost efficient means to make investment decisions based on the direction of the market as a whole" (App. 69) and that "the listing and trading of IPs on national securities exchanges may reduce market volatility associated with program trades of stock." (App. 68). The SEC found all of the rules proposals to be consistent with the applicable provisions of the Exchange Act.[6] (App. 82 and 107).

Pursuant to Section 25(a) of the Exchange Act, 15 U.S.C. §78y(a) (1988), CME and CBT filed petitions to review the SEC orders approving the proposed rules of the three exchanges (No. 89-1763) and OCC (No. 89-1786).[7]

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[5] The SEC found that IPs possessed the key characteristics of stock (App. 49-52) and to the extent that IP characteristics differed from those of stock, they resembled the characteristics of rights to purchase or puts or calls on a security or index of securities (App. 52).

[6] The SEC also issued an order under its Rule 9b-1 approving the disclosure document for IPs prepared by OCC and the exchanges (Order Approving Proposed Index Participations Disclosure Document, SEC Release No. 34-26752, 43 SEC Docket 1144 (April 21, 1989)), as well as an order declaring OCC's registration statement for IPs under the 1933 Act to be effective. (SEC File No. 33-28140 (April 21, 1989)). No appeal was taken from those orders.

[7] Two other petitions to review were filed in the Court of Appeals. The first (No. 89-1538), which was filed by CME and CBT,

(Footnote continued on following page)

Decision Of The Court Below

On August 18, 1989, the Court of Appeals rendered its opinion. The thrust of the Court's decision was that IPs did not fit comfortably within either the definitions of "security" under the securities laws or the traditional meaning of "futures contracts" under the CEA. The Court stated that IPs had properties similar to those of a security from the purchaser's perspective and properties similar to a futures contract from the seller's perspective.[8] (App. 2-3). The Court then held that, although IPs did not have all of the attributes of conventional futures contracts, there was no more reason strictly to construe the reach of the CEA than that of the securities laws—that if IPs were securities then they were also futures contracts subject to the exclusive jurisdiction of the CFTC under the provisions of Section 2(a)(1) of the CEA,

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[7] *continued*
was dismissed by the Court of Appeals for want of jurisdiction. The second (No. 89-2012) was filed by the ICI to reverse the SEC's determination that IPs were not investment company securities subject to the ICA. The Court of Appeals did not decide the issues raised by ICI's petition in light of its disposition of Nos. 89-1763 and 89-1786. (App. 25).

[8] Section 25(a)(4) of the Exchange Act, 15 U.S.C. §78y(a)(4) (1988), provides that the findings of the SEC as to facts are conclusive when supported by substantial evidence. Yet the Court of Appeals ignored the SEC's finding that IPs provided a vehicle for retail customers to invest in the market, which would have clearly established them as securities. *Reves v. Ernst & Young*, U.S. , 58 U.S.L.W. 4208 (February 21, 1990) ("Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment." 58 U.S.L.W. at 4209.) On the other hand, the Court of Appeals supplied a finding—one never made by the SEC—that sellers of IPs see the IP "as a speculative or hedging instrument scarcely distinguishable from a futures contract that terminates on the cash-out day." (App. 3). It is unclear what the basis was for the Court of Appeals' intuition regarding the states of mind of sellers of IPs.

7 U.S.C. §§2, 2a (1988). Accordingly, the Court of Appeals set aside the SEC's orders approving the IPs rules of the three exchanges and OCC.[9]

The Court of Appeals noted that the portion of the definition of "security" in Section 3(a)(10) of the Exchange Act, 15 U.S.C. §78c(a)(10) (1988), which most closely matches an IP is the language, which was added by the 1982 amendments to the securities laws (Act of October 13, 1982, Pub. Law 97-303, 96 Stat. 1409), covering a "privilege on any security . . . or group or index of securities (including any interest therein *or based on the value thereof*)" [emphasis in original]. (App. 15). The Court stated in as many words that "IPs convey privileges based on the value of an index." (App. 15). However, for reasons that do not appear on the face of the opinion, the Court did not consider the applicability of another section added by the 1982 amendments—Section 9(g) of the Exchange Act, 15 U.S.C. §78i(g) (1988)—which provides that "[n]otwithstanding any other provision of law, the [SEC] shall have the authority to regulate the trading of any . . . privilege on any . . . group or index of securities (including any interest therein or based on the value thereof) . . . ."

Ignoring the significance of its finding that IPs convey privileges based on the value of an index (and that consequently the SEC had the authority under Section 9(g) of the Exchange Act, "[n]otwithstanding any other provision of law," to regulate the trading of IPs whether or not IPs were

[9] During the pendency of the proceedings before the Court of Appeals, the SEC orders were not stayed by either the SEC or the Court of Appeals. Trading in IPs commenced on the AMEX and PHLX, but not on the CBOE. After the Court of Appeals issued its opinion, but before its mandate was effective, all trading of IPs was terminated by the exchanges and the open positions in outstanding IPs were closed out in accordance with the rules of OCC.

also options), the Court focused instead on its conclusion that "an IP is not an option on a security." (App. 17). Even that conclusion is questionable in the extreme. In reaching it, the Court limited the definition of option to what it regarded—without support in the record[10]—to be the paradigm for standardized options. Yet, the Court did not say why options should be construed in a narrow, crabbed way to deny the SEC's jurisdiction to regulate them, while, at the same time, giving a broad and expansive meaning to "futures contracts."

On October 23, 1989, the Court of Appeals issued another opinion, prompted by the petitions for rehearing and suggestions of rehearing *en banc* of the petitioners, the SEC, and PHLX. In that opinion the Court made it clear that it regarded IPs as both securities and futures contracts—that is, as "investment vehicles" from the perspective of the purchasers and as instruments that "look like futures contracts" from the perspective of the sellers. (App. 109). If IPs are futures contracts, then, the Court held, the CFTC has exclusive jurisdiction under Section 2(a)(1)(B)(ii) of the CEA. *Id.* Again, the Court failed to address—directly or otherwise—the applicability of Section 9(g) of the Exchange Act.[11] The

[10] The Court erroneously stated that "options are written 'out of the money' " (App. 18); that the "writer retains dividends" (App. 18); and that options, unlike futures, "call for delivery of the underlying instruments." (App. 11). In fact, options are often written "in the money" (were they not, options would become illiquid as soon as they became profitable to exercise); options traded in the over-the-counter market are generally adjusted for dividends and standardized options are adjusted for certain extraordinary dividends; and all index options, like futures, are cash-settled. Indeed, Section 28(a) of the Exchange Act, 15 U.S.C. §78bb(a) (1988), was amended in 1982 for the express purpose of preempting state laws that might otherwise have invalidated cash-settled options and other cash-settled securities traded on national securities exchanges. *See* H.R. Rep. No. 626, 97th Cong., 2d Sess., pt. 1 at 9, *reprinted in* 1982 U.S. Code Cong. & Admin. News 2780, 2787.

[11] OCC called this issue to the Court's attention in three separate briefs, and this point was accepted and endorsed by the SEC in one of its briefs.

Court also noted, in response to an argument made by PHLX, that even though the IPs traded on PHLX gave holders the right to exercise the privilege on a daily basis, those IPs still had the requisite element of futurity because the holders received only 99.5% on the index value. (App. 110). The Court did not decide whether an IP with a daily privilege to receive 100% was a futures contract, nor did it explain why the 0.5% difference should determine which agency has regulatory jurisdiction. (App. 110).

REASONS FOR GRANTING THE WRIT

I.

THE RESOLUTION OF THE KEY ISSUE RAISED BY THIS CASE—WHICH FEDERAL REGULATORY SCHEME WILL GOVERN INNOVATIVE FINANCIAL INSTRUMENTS—WILL SHAPE THE FUTURE DEVELOPMENT AND COMPETITIVENESS OF THE NATION'S FINANCIAL MARKETS.

This case presents, as a matter of first impression, a fundamental jurisdictional question under two different statutory schemes (the federal securities laws and the CEA) that is of vital importance to the development and regulation of the trading markets for a growing number of new types of financial instruments. The resolution of this question will not only determine which federal agency has regulatory authority over these instruments, it will also have important consequences for the development and competitiveness of the nation's financial markets. It will determine the type of market in which these new instruments may be traded and the forms they will take, the manner in which professional participants in those markets will be regulated, and the nature and extent of the statutory protections that will be available to public investors.

Whether these financial instruments are subject to regulation by the SEC or CFTC is not, therefore, simply a "turf" battle between two federal agencies. Rather, the resolution of this question will determine which of two distinct sets of regulatory protections is available to public investors. For example, if these new instruments—which are sold as investments and deemed to be securities from the perspective of the purchaser[12] —are subject to regulation under the securities laws, then public investors are entitled to the benefit of a number of regulatory safeguards, including: the disclosure obligations of the 1933 Act and, in this case, of SEC Rule 9b-1, the regulatory protections of the State securities laws,[13] and the insurance protections afforded by the Securities Investor Protection Act of 1970, as amended, 15 U.S.C. 78aaa-78*lll* (1988). If, however, these instruments are subject to the exclusive jurisdiction of the CFTC under the CEA because they "look like" futures contracts from the perspective of the sellers (App. 109), then these safeguards will not be available to public investors. Thus, this Court's determination as to the choice of regulatory schemes intended by Congress is a matter of great importance to public investors.[14]

[12] "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." *Reves v. Ernst & Young*, 58 U.S.L.W. at 4209 [emphasis in original].

[13] Section 28(a) of the Exchange Act, 15 U.S.C. §78bb(a) (1988), expressly preserves the jurisdiction of State securities laws insofar as they do not conflict with the provisions of the Exchange Act. In contrast, State regulatory laws are totally preempted with respect to matters that are within the exclusive jurisdiction granted to the CFTC under Section 2(a)(1) of the CEA, 7 U.S.C. §§2, 2a (1988).

[14] Neither this Court nor the Court of Appeals has ever examined whether the existence of the regulatory scheme established by the CEA renders the protections of the securities laws unnecessary for public investors. *See, e.g., Reves v. Ernst & Young*, 58 U.S.L.W. at 4211; *Marine Bank v. Weaver*, 455 U.S. 551, 557-59 (1982).

Moreover, the resolution of this question will determine whether these new forms of securities, which provide small investors with the ability to invest in market baskets of common stocks, will be subject to the regulatory scheme established by Congress for the purpose of "preventing the excessive use of credit for the purchase or carrying of securities." Section 7(a) of the Exchange Act, 15 U.S.C. §78g(a) (1988). In contrast, no federal authority has the jurisdiction to set, or to oversee the setting of, levels of margin on futures contracts subject to the exclusive jurisdiction of the CFTC. Sections 5a(12) and 8a(7) of the CEA, 7 U.S.C. §§7a(12) and 12a(7) (1988). Thus, if these instruments are deemed to be futures contracts as well as securities, one of Congress' major purposes in enacting the Exchange Act will have been thwarted.

The question as to which regulatory scheme applies will also determine the type of market in which the instruments will be able to be traded, the form of the instruments, and the qualifications of the persons authorized to sell and to trade them. Indeed, the question may determine whether these useful new securities will be able to be marketed at all in the United States. Under the CEA, no one can trade a futures contract in the United States otherwise than on a board of trade designated by the CFTC as a "contract market" for the instrument or otherwise than through a member of such contract market.[15] Section 4a of the CEA, 7 U.S.C. §6a(1) (1988). This means that there will be no trading in the United States in any new instrument that might be deemed to be a futures contract as well as a security unless a commodity board of trade sponsors the instrument and is able

[15] In contrast, securities may be traded on exchanges, in the over-the-counter market, or in privately negotiated transactions—whether through broker-dealers or not—provided only that if such trading takes place through the facilities of an exchange or other self-regulatory organization, it must do so in conformity with rules of the organization that have been approved by the SEC.

to obtain the CFTC's approval for the right to trade it.[16] It also means that the new products could be lawfully marketed only by persons qualified under the CEA to act as brokers and salesmen, and that the much larger group of persons who are qualified under the Exchange Act to act in those capacities will be unable to market this product. Finally, as the SEC found, many investors also may be effectively prohibited from participating in futures markets as a result of regulatory constraints or contractual prohibitions. (App. 61). All of this means that, as a result of the Court of Appeals holding, these useful new securities may not be available at all in the United States.

If they are made available, but only on futures exchanges, they will be less useful as a result of being placed under a regulatory scheme designed for a very different type of product, and the form of the instrument would undoubtedly have to be changed. For example, the IPs designed by AMEX give purchasers a privilege to obtain physical delivery of the stocks comprising the underlying index. The SEC found that the availability of this privilege permits institutions to use these IPs to adjust their stock portfolios and that, as a result, these IPs have a greater potential for providing the liquidity benefits envisioned for market baskets. (App. 69). Yet, because these securities have been held to be futures contracts from the sellers' perspective and subject

[16] It is not clear that the CFTC's rules would permit it to grant such approval for products like IPs. In order to qualify for continued designation to trade, a futures contract must be shown to have "served a hedging or price basing function on more than an occasional basis." 17 C.F.R. Part 5, Appendix A, item C(5) (1989). IPs were designed primarily as investment vehicles for retail customers. The substantial up-front costs involved in purchasing and selling IPs make them unsuitable for hedging and price discovery functions, which are much more efficiently performed by stock index futures.

to the exclusive jurisdiction of the CFTC, this valuable physical delivery feature cannot be incorporated into the instrument.[17]

The uncertainty created by the Court of Appeals opinion as to which regulatory scheme will apply to innovative securities products leaves participants in the securities markets in a quandary. A securities exchange that wishes to become a market for the trading of an instrument that might be argued to be a futures contract as well as a security cannot be sure with which federal agency it should file for approval, and the agencies themselves do not know whether they should process the filings. Even if one agency should approve a particular proposal, until the questions presented by this case are definitively settled by this Court, no participant in the markets can be confident that its actions in conformity with one federal regulatory scheme will not be held to be in violation of the other. The development and introduction of new securities products involve substantial time, effort, and expense. Jurisdictional confusion and questions as to legality can only delay the introduction of new securities products that could serve important economic purposes and help maintain the competitiveness of the financial markets of the United States.[18]

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[17] Section 2(a)(1)(B)(ii)(I) of the CEA, 7 U.S.C. §2a(ii)(I) (1988), provides that no board of trade may be designated as a contract market for stock index futures contracts or options thereon unless "[s]ettlement of or delivery on such contract (or option on such contract) shall be effected in cash or by means other than the transfer or receipt of any security . . . ."

[18] IPs are being traded in the over-the-counter market in Canada and on the Toronto Stock Exchange. According to one report, this was possible because "Canadian regulators have managed to avoid the turf battle that engulfed" the IPs designed by PHLX and AMEX. *Investor's Daily*, March 19, 1990, at p. 11.

II.

THE COURT OF APPEALS HOLDING CREATES UNCERTAINTY AS TO THE MEANING OF "FUTURES CONTRACT," CASTS DOUBT UPON THE EXTENT OF THE SEC'S JURISDICTION OVER BOTH NEW AND EXISTING INVESTMENTS, AND FRUSTRATES THE INTENT OF CONGRESS.

The CEA grants exclusive jurisdiction to the CFTC to regulate transactions involving "contracts of sale of a commodity for future delivery" (that is, "futures contracts"). CEA §2(a)(1)(A), 7 U.S.C. §2 (1988). Except for this grant of exclusive jurisdiction over futures contracts, the CEA provides that nothing contained therein "shall (i) supersede or limit the jurisdiction at any time conferred on the [SEC] or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the [SEC] and such other authorities from carrying out their duties and responsibilities in accordance with such laws." *Id.* This latter provision is sometimes referred to as the "SEC saving clause."

This jurisdictional scheme was added to the bill that created the CFTC by an amendment proposed by the Senate Committee on Agriculture and Forestry. In describing the exclusive jurisdiction clause, Senate Report No. 93-1131 stated:

> While the Committee did wish the jurisdiction of the [CFTC] to be exclusive with regard to the trading of *futures on organized contract markets,* it did not wish to infringe on the jurisdiction of the [SEC] or other government agencies.

S. Rep. No. 1131, 93rd Cong., 2d Sess., at 3, *reprinted in* 1974 U.S. Code Cong. & Admin. News 5843, 5863 [emphasis supplied].

Thus, the issue boils down to what Congress meant by "futures" when it enacted this provision granting the CFTC exclusive jurisdiction over "futures" but otherwise not wishing to infringe on the SEC's jurisdiction. Are futures to be defined in some amorphous, expansive way, as the Court below did, with the result that the SEC's jurisdiction over a wide array of new and traditional financial instruments is shifted to the CFTC, or are they to be defined in reference to the type of instrument that Congress described when this jurisdictional provision was added to the CEA?

Unfortunately, the CEA contains no definition of futures contract. The Senate Report contains a glossary definition of futures contract,[19] but it warns that the glossary is not to be deemed a guide to interpretation of the CEA or statements in the Report. *Id.* at 5891. Nevertheless, the Senate Report describes futures trading in a manner similar to the glossary definition, saying: "Futures trading involves purchases and sales of contracts for delivery at some future date of certain quantities of specified commodities at fixed prices." *Id.* at 5856. The Senate Report also describes the manner in which daily payments are made between the futures clearing house and its members to reflect daily price changes in futures contracts, a manner which is incompatible with IPs and other securities.[20] *Id.* at 5858.

In deciding that IPs are futures contracts subject to the exclusive jurisdiction of the CFTC, the Court of Appeals furnished a definition of a "futures contract." It stated:

> A futures contract, roughly speaking, is a fungible promise to buy or sell a particular commodity *at a fixed date in the future*. (App. 8-9). [Emphasis supplied.]

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[19] The glossary defines "futures contract" as "contracts for the purchase and sale of commodities for delivery some time in the future on an organized exchange and subject to all terms and conditions included in the Rules of that Exchange." *Id.* at 5892.

[20] *See* n. 5, supra.

However, the Court neither followed that definition nor supplied a new one.[21] The reasons the Court gave for finding that IPs are futures contracts provide little guidance other than to suggest that the application of the securities laws to a wide range of securities is now suspect.

First, the Court of Appeals noted that there was a congruence of futures and IPs from the perspective of their sellers.[22] (App. 15-16). However, there is at least as great a congruence of standardized options and IPs from this same perspective, and the Court rejected the notion that IPs are options.[23] Three types of instruments—futures contracts, options and IPs—all have similarities from their sellers' viewpoint. Yet, although it is plain that options are not futures and futures are not options, the Court held that IPs are futures contracts and not options. The Court stated that the

[21] It is clear that IPs are *not* contracts to buy and sell the value of the underlying index "at a fixed date in the future." The dates on which IP sellers are obligated to pay the value of the underlying index are not fixed in advance. Rather, they are determined by when IP holders choose to exercise their privileges to receive the value of the underlying index.

[22] The Court of Appeals found IPs to be securities from the perspective of the buyers and futures contracts from the perspective of the sellers, but it held that neither "is the 'privileged' perspective." (App. 109). In so holding, the Court ignored Section 2(a)(1)(B)(i) of the CEA, which provides that the CEA shall not apply to "any transaction whereby any party *acquires* any put, call or *other option* on one or more securities . . . , including any group or index of such securities, or any interest therein or based on the value thereof." 7 U.S.C. §2(a)(i) (1988) [emphasis supplied]. Clearly, Congress intended the perspective of the acquiring party to be controlling for jurisdictional purposes.

[23] One of the reasons the Court gave for holding that IPs were not options is that IPs have indefinite duration while, as the Court held, options are "limited in time." (App. 18). However, futures contracts are also limited in time, and the Court leaves uncertain why it is dispensing with the "fixed date in the future" requirement for futures but not for options.

"very features that the SEC emphasizes to show that IPs are securities—indefinite duration, payment up front in cash, dividend equivalency, and so on—show that IPs cannot be options." (App. 18). But these same features should distinguish IPs from futures contracts as well, since futures contracts long have had the attributes of fixed term, no payment up front and no dividend equivalency. What is unclear is why these features can be ignored in considering whether an instrument is a futures contract but given great weight in considering whether it is an option.

Second, the Court of Appeals rejected the one element that distinguishes a futures contract from an option—namely, "bilateralism." (App. 21). Traditional futures contracts—that is, the kind described in the Senate Report (*supra*, at 16)—are bilateral. Both the buyer and the seller are obligated to perform at some fixed future date. On the other hand, an option is not bilateral; although the seller is obligated to perform at some future date, the buyer is not. Thus, the sellers of futures and of options have the same obligations; the instruments differ only from the viewpoint of the buyer. The CFTC, in its brief as *amicus curiae*, characterized bilateral obligation as an "essential element of a futures contract."[24] The Court of Appeals recognized that "bilateralism" was missing in IPs, but held that bilateralism was not essential to a futures contract notwithstanding the CFTC's express statement that it was (App. 21). Thus, the Court in effect merged futures and options by eliminating the one element that distinguished them, thereby throwing into further uncertainty the means of fixing the line between the two types of products.[25]

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[24] Brief of Commodity Futures Trading Commission as *Amicus Curiae* at 15.

[25] The Court recognized that "it is almost always possible to devise an option with the same economic attributes as a futures contract (and the reverse)." (App. 11).

Third, the Court of Appeals found IPs to have "futurity" in the sense that their holders have the privilege to exercise the IP on a future date and to receive the value of the underlying index on that date. (App. 16). If this is the type of "futurity" that turns a security into a futures contract, then it will remove a wide array of securities from the application of the securities laws. For example, an option on a stock index that is exercisable only at expiration (called a "European-style option")—which is a type of option issued by OCC under SEC regulation—obligates the short to pay the value of the index at expiration if the option is exercised, which it surely will be if it is "in the money" at expiration. The obligations of the sellers of IPs and the writers of such European-style options are indistinguishable. Similarly, the holder of shares of an open-end mutual fund has the right to redeem his shares each day in the future and to receive the value of his proportionate share of the fund's portfolio on the date he redeems. Other examples include zero-coupon bonds (where the holder pays a present value in exchange for the right to be paid a future value at a specified future date); index warrants (where the holder has the right to be paid an amount based on the value of a specified index at some future date);[26] and variable annuities (where the holder is entitled to future payments based on the values accumulated over time). It would seem clear that mere "futurity" does not make a futures contract,[27] but what more is needed remains uncertain under the Court of Appeals opinion.

[26] These types of warrants are now listed on AMEX, and the New York Stock Exchange is applying to the SEC for approval to list similar types of warrants. These warrants have been among the most actively traded issues on AMEX since trading began on February 15, 1990.

[27] Indeed, virtually every exchange contract for the purchase of a security involves "futurity" in the sense that delivery and payment will be made "at a fixed date in the future." Congress obviously intended that there be something more than a reliance on the word "future."

The Court of Appeals in effect acknowledges this when it states:

> Fact is, it is no less a future than it is a security, and no more. It just doesn't fit. (App. 17).

And when it says:

> "These products are valuable to the extent that they do *not* match the attributes of instruments already available." (App. 13). [Emphasis in original.]

Later, the Court says that "the IP is both a security and a futures contract. It has some attributes of both, and all attributes of neither . . . ."[28] (App. 20). It then decides that the definition of "futures contract" should be no less broad than the definition of "security."

The exclusive jurisdiction clause of the CEA is strong medicine. It exempts an instrument from regulation under every federal and state regulatory statute except the CEA. Applying it to instruments that are offered, traded, cleared, and settled as securities, that are expressly found by the SEC to be securities, that are futures contracts only under a strained and expansive interpretation of that term, and that did not even exist when Congress enacted the exclusive jurisdiction clause, is surely not what Congress intended.[29] The SEC saving clause evinced a concern on the part of Congress that the jurisdiction of the SEC not be limited by the CEA "except as hereinabove provided"—*i.e.*, except to the extent required by the exclusive jurisdiction clause. That clause

[28] Since the SEC expressly found that IPs were designed as investments for retail customers (App. 69 n. 96), it would seem that they do have all the attributes of a security under the doctrine of *Reves v. Ernst & Young*, *supra* n. 8.

[29] The Court of Appeals itself suggested that Congress might think it wise to "relax" an exclusivity clause interpreted as broadly as the Court of Appeals interpreted it. (App. 109-10).

gives the CFTC exclusive jurisdiction over transactions involving "contracts of sale of a commodity for future delivery." To interpret that phrase expansively, as the Court of Appeals did, so that it encompasses not only the types of futures contracts described in the legislative history that accompanied the enactment of the exclusive jurisdiction clause,[30] but also entirely new financial instruments that are clearly securities, is to reduce the SEC saving clause to a nullity.

If the Court of Appeals decision is to stand—if instruments are to be deemed to be futures contracts because they have some similarities to futures contracts (while the differences are ignored)—then the intent of Congress in enacting the SEC saving clause will be frustrated and the extent to which both new and existing securities will be subject to the securities laws will remain uncertain.

III.

THE COURT OF APPEALS IGNORED, AND HAS THEREBY IN EFFECT REPEALED, ONE OF THE PRINCIPAL JURISDICTIONAL PROVISIONS OF THE EXCHANGE ACT.

In the 1982 amendments to the securities laws, Congress expanded the definition of "security" in Section 3(a)(10) of the Exchange Act, 15 U.S.C. §78c(a)(10) (1988), and in the other securities laws to make it clear that any "privilege on any . . . group or index of securities (including any interest therein or based on the value thereof)" is itself a security for the purposes of the securities laws. The 1982 amendments then added a new Section 9(g), 15 U.S.C. §78i(g) (1988), which provides that "[n]otwithstanding any other provision of law," the SEC is to have the authority to regulate the trading of "any put, call, straddle, option, or privilege on any

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[30] *See* n. 19 and accompanying text, *supra*.

... group or index of securities (including any interest therein or based on the value thereof)." It is clear from the legislative history that only the SEC, and not the CFTC, was to have authority with respect to these types of instruments.[31]

The term "privilege" is not defined in the Exchange Act. However, its juxtaposition in Section 9(g) with the terms "put," "call," "straddle," and "option" suggests that it was intended to refer to an instrument conveying rights similar, but not identical, to those conveyed by an option. The rights conveyed by IPs fit that description. As the SEC noted:

> To the extent certain IP characteristics differ somewhat from the characteristics of stock, they resemble characteristics commonly found in rights to purchase or puts or calls on a security or index of securities .... (App. 52).

The Court of Appeals itself expressly stated that "IPs convey privileges based on the value of an index" (App. 15). Yet it failed entirely to consider the applicability of Section 9(g). Instead, it merely concluded—notwithstanding the many ways in which the SEC found IPs to be similar to standardized options (*supra*, at 5-6)—that IPs were not "options."[32]

In the allocation of jurisdiction between the SEC and the CFTC, it is important to eliminate any uncertainties concern-

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[31] H.R. Rep. No. 626, 97th Cong., 2d Sess., pt. 1 at 9 and pt. 2 at 11-16, *reprinted in* U.S. Code Cong. & Admin. News 2780, 2787 and 2801-6.

[32] If, as the Court of Appeals says, it is not going to apply *strictissimi juris* to the CEA (App. 23), why does it do so with respect to this important provision of the Exchange Act? The Court incorrectly implies that the SEC found that IPs are not "options." (App. 17). The SEC expressly noted that IPs have characteristics of options (App. 52 n. 57) and, as noted above, that IPs have characteristics resembling those commonly found in puts or

(Footnote continued on following page)

ing the meanings of the terms used in jurisdictional provisions such as Section 9(g), and not simply to ignore the entire issue. Although IPs contain a "privilege" which brings them within the literal language of Section 9(g) of the Exchange Act, the Court of Appeals persistently disregarded Section 9(g) and assigned jurisdiction as though it had never been enacted.[33] This Court should examine the Court of Appeals' implicit repealer of Section 9(g).

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[32] *continued*
calls (App. 52). Moreover, the SEC specifically eschewed pigeonholing IPs exclusively into any of the specific definitions contained in Section 3(a)(10) of the Exchange Act; it identified a variety of instruments described in the Exchange Act to which IPs can be analogized, and did not foreclose the possibility that IPs could fit within other categories under Section 3(a)(10). (App. 48 n. 47). *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967) (an instrument may simultaneously fit within several of the enumerated definitions under Section 3(a)(10)).

[33] *See* n. 11, *supra*.

CONCLUSION

The Court of Appeals has erroneously decided important questions of federal law which should be reviewed and settled by this Court. Petitioners respectfully request that a writ of certiorari issue to review the judgments of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

BURTON R. RISSMAN,
Counsel of Record

ROGER PASCAL
WILLIAM H. NAVIN
Schiff Hardin & Waite
7200 Sears Tower
Chicago, Illinois 60606
(312) 876-1000
Attorneys for The Options Clearing Corporation

MAHLON M. FRANKHAUSER
Lord Day & Lord,
Barrett Smith
1201 Pennsylvania Avenue, N.W.
Suite 821
Washington, D.C. 20024
(202) 393-5024
Attorney for American Stock Exchange, Inc.

NANCY R. CROSSMAN
Chicago Board Options Exchange, Incorporated
LaSalle at Van Buren
Chicago, Illinois 60605
(312) 786-5600
Attorney for Chicago Board Options Exchange, Incorporated

Attorneys for Petitioners

Of Counsel:

DON L. HORWITZ
General Counsel
The Options Clearing Corporation

DATED: March 22, 1990

89-1502

Nos.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

AMERICAN STOCK EXCHANGE, INC., CHICAGO BOARD OPTIONS EXCHANGE, INCORPORATED, AND THE OPTIONS CLEARING CORPORATION,

Petitioners,

v.

CHICAGO MERCANTILE EXCHANGE, *et al.*,

Respondents.

PHILADELPHIA STOCK EXCHANGE, INC.,

Petitioner,

v.

CHICAGO MERCANTILE EXCHANGE, *et al.*,

Respondents.

PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT (SEVENTH CIRCUIT NOS. 89-1763 and 89-1786)

JOINT APPENDIX OF PETITIONERS

BURTON R. RISSMAN
Counsel of Record
ROGER PASCAL
WILLIAM H. NAVIN
Schiff Hardin & Waite
7200 Sears Tower
Chicago, Illinois 60606
(312) 876-1000
Attorneys for The Options Clearing Corporation

EARL H. NEMSER
Counsel of Record
Cadwalader, Wickersham & Taft
100 Maiden Lane
New York, New York 10038
(212) 504-6000
Attorneys for Philadelphia Stock Exchange, Inc.

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APPENDIX A

In the

United States Court of Appeals

For the Seventh Circuit

Nos. 89-1538, 89-1763, 89-1786, and 89-2012

CHICAGO MERCANTILE EXCHANGE, BOARD OF TRADE OF THE CITY OF CHICAGO, and INVESTMENT COMPANY INSTITUTE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent,

and

PHILADELPHIA STOCK EXCHANGE, INC., OPTIONS CLEARING CORPORATION, AMERICAN STOCK EXCHANGE, INC., and CHICAGO BOARD OPTIONS EXCHANGE, INC.,

Intervening Respondents.

Petitions for Review of Orders of
the Securities and Exchange Commission.

ARGUED JUNE 9, 1989—DECIDED AUGUST 18, 1989

Before BAUER, *Chief Judge*, EASTERBROOK, *Circuit Judge*, and FAIRCHILD, *Senior Circuit Judge.*

EASTERBROOK, *Circuit Judge.* The Commodity Futures Trading Commission has authority to regulate trading of futures contracts (including futures on securities) and options on futures contracts. The Securities and Exchange

Commission has authority to regulate trading of securities and options on securities. If an instrument is both a security and a futures contract, the CFTC is the sole regulator because "the Commission shall have exclusive jurisdiction with respect to . . . transactions involving . . . contracts of sale (and options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the value thereof)", 7 U.S.C. §2a(ii). See also 7 U.S.C. §2 ("the Commission shall have exclusive jurisdiction, except to the extent otherwise provided in section 2a of this title"); *Chicago Board of Trade v. SEC*, 677 F.2d 1137 (7th Cir.), vacated as moot, 459 U.S. 1026 (1982) (*GNMA Options*). If, however, the instrument is both a futures contract and an option on a security, then the SEC is the sole regulator because "the [CFTC] shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities . . . including any group or index of such securities, or any interest therein or based on the value thereof." 7 U.S.C. §2a(i).

The CFTC regulates futures and options on futures; the SEC regulates securities and options on securities; jurisdiction never overlaps. Problem: The statute does not define either "contracts . . . for future delivery" or "option"—although it says that " 'future delivery' . . . shall not include any sale of any cash commodity for deferred shipment or delivery". See Lester G. Telser, *Futures and Actual Markets: How They Are Related*, 59 J. Business S5 (1986). Each of these terms has a paradigm, but newfangled instruments may have aspects of each of the prototypes. Our case is about such an instrument, the index participation (IP). We must decide whether tetrahedrons belong in square or round holes.

I

Index participations are contracts of indefinite duration based on the value of a basket (index) of securities. The seller of an IP (called the "short" because the writer need

not own the securities) promises to pay the buyer the value of the index as measured on a "cash-out day". Any index, such as the Standard & Poor's 500, can be used. The buyer pays for the IP in cash on the date of sale and may borrow part of the price (use margin) on the same terms the Federal Reserve sets for stock—currently 50%. The exchange designates a conversion ratio between the index and the IP, so that (say) each IP unit entitles the holder on cash-out day to the value of the index times 100. Until cash-out the IP may trade on the exchange just like any other instrument. At the end of each quarter the short must pay the buyer (the "long") a sum approximating the value of dividends the stocks in the index have paid during the quarter. From the perspective of the long, then, an IP has properties similar to those of a closed-end mutual fund holding a value-weighted portfolio of the securities in the index: the IPs last indefinitely, pay dividends, and may be traded freely; on cash-out day the IP briefly becomes open-end, and the investor can withdraw cash without making a trade in the market.

Things differ from the short's perspective. Unlike the proprietor of a mutual fund, the short need not own the securities in the index; it will own them (equivalently, a long futures contract based on the same index) only to reduce risk. The short receives the long's cash but must post margin equal to 150% of the value of the IP, similar to the margin required for a short sale of stock. The short sees the IP as a speculative or hedging instrument scarcely distinguishable from a futures contract that terminates on the cash-out day, plus an option held by the long to roll over the contract to the next cash-out date. Cash-out days for an IP generally are the third Friday of March, June, September, and December, the expiration dates of the principal stock-index futures contracts, making the link even more apparent.

Longs and shorts do not deal directly with each other. After the parties agree on the price, the Options Clearing Corporation (OCC) issues the IP to the long, receiving the cash; at the same time the OCC pays the short

and "acquires" the short's obligation to pay at cash-out time. OCC guarantees the short's obligations to the long, to secure which it holds the short's 150% margin. As the quarter progresses the short must pony up cash to cover dividend-equivalent obligations. When a long exercises the cash-out privilege, the OCC chooses a short at random to make the payment. Any link between the original buyer and seller of an IP thus does not extend beyond the formation of the instrument; after that instant, each person's rights and obligations run to the OCC exclusively. This arrangement also permits either party to close its position by making an offsetting transaction. If the seller of an IP buys an identical contract in the market, the OCC cancels the two on its books.

The Philadelphia Stock Exchange asked the SEC in February 1988 for permission to trade IPs. The American Stock Exchange and the Chicago Board Options Exchange later filed proposals of their own. Each exchange's IP differs slightly from the others. Philadelphia's IP, called a "Cash Index Participation", allows the long to exercise the cash-out privilege on any business day, at a discount of 0.5% from the value of the index. (The long may cash out on a quarterly date without penalty.) The AMEX's IP, called the "Equity Index Participation", permits the long to cash out quarterly for money or shares of stock in a ratio matching the index. Holders of 500 or more EIP trading units based on the S&P 500 index (each the equivalent of 100 multiples of that index) may exercise the right to receive securities, and they must pay a "delivery charge" to be established by the AMEX. Writers of EIPs may volunteer to deliver stock; if not enough do, a "physical delivery facilitator" at the AMEX will buy stock in the market, using money provided by the shorts whose positions have been liquidated. The CBOE's product, the "Value of Index Participation", has a semi-annual rather than quarterly cash-out date. CBOE's wrinkle is that the short as well as the long may cash out, by tendering the value of the index on the cash-out date. If shorts seeking to close their positions exceed the number of longs

who want cash, the OCC will choose additional long positions at random to pay off.

The three stock exchanges and the OCC asked the SEC to allow them to trade these varieties of IP. Each contended that the SEC has exclusive jurisdiction because IPs are securities and not futures contracts. The AMEX added that in its view an IP is an option on securities, activating the savings clause of §2a(i). The Chicago Board of Trade and the Chicago Mercantile Exchange, supported by the CFTC, asked the SEC to deny the requests. Each futures market, and the CFTC, argued that IPs are futures and not securities, so that the CFTC's jurisdiction is exclusive under 7 U.S.C. §§ 2 and 2a(ii). Complicating the picture, the Investment Company Institute argued that if IPs are securities and not futures, the OCC is an "investment company", offering a product combining features of closed-end and open-end mutual funds, and must register under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64.

On April 11, 1989, the SEC granted the exchanges' requests. Release No. 34-26709, 54 Fed. Reg. 15280 (1989). At the same time, its Division of Market Regulation, acting with delegated authority, allowed the OCC to change its rules so that it could issue, settle, and clear IPs. Release No. 34-26713, 54 Fed. Reg. 15575 (1989). The SEC concluded that IPs are "stock" within the meaning of §3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. §78c(a)(10). IPs are negotiable, pay dividends, may appreciate in value, and may be hypothecated; the only attribute of stock missing from IPs is voting rights, which the SEC thought unimportant. 54 Fed. Reg. at 15285-86. If not stock, the SEC concluded, IPs are "certificates of interest or participation in" stock, another of the instruments defined as "securities" in §3(a)(10). See 54 Fed. Reg. at 15286.[1] Next the SEC found that IPs are not

[1] Commissioner Cox, while otherwise joining the SEC's opinion, disavowed reliance on the contention that IPs are "stock" but agreed with his colleagues that they are "certificates of interest or participation". 54 Fed. Reg. at 15293.

"futures", *id.* at 15286-89, because they lack two features the SEC thought essential: "futurity" and "bilateral obligation". "Futurity" means that value is set in the future, while as the SEC observed the buyer of an IP pays a price fixed at the time of sale; "bilateral obligation" means that the contract is executory on both sides until expiration or settlement, while the long on an IP performs at the time of purchase, leaving only the short with executory obligations. The SEC went on to say, *id.* at 15289-90, that the OCC need not register under the Investment Company Act because there is no "issuer" within the meaning of §3(a)(1) of that statute, 15 U.S.C. §80a-3(a)(1). Concluding that IPs may serve as substitutes for "program trading", provide "an additional layer of liquidity to the market", and afford "an alternative vehicle for retail customers to invest in 'the market' ", 54 Fed. Reg. at 15290, the SEC allowed the exchanges to proceed with their plans. We denied the futures markets' request for a stay but accelerated the hearing of the case on the merits. IPs have been trading on the three exchanges since May.

II

Three preliminary matters.

First, the futures markets are not plagued by regulation of their own activities. They complain, instead, that the SEC has passed up an opportunity to throttle three competitors. The futures markets may obtain relief only if there is a case or controversy within the meaning of Article III, and then only if they fall within the zone of interests protected by the Securities Exchange Act and the exclusivity clauses of the Commodity Exchange Act. The last time a dispute of this character was before us, we held that the futures markets have standing, *GNMA Options*, 677 F.2d at 1140-41 n.4, but did not mention the "zone" question. Our opinion in *Chicago Board of Trade v. SEC*, No. 89-1084 (7th Cir. Aug. 17, 1989) (*Delta Options*), requires decision in the futures markets' favor. *Delta Options* concludes that the futures markets may

challenge the registration of a clearing agency that facilitates transactions for their competitors, even though the futures markets' interests may be adverse to those of investors. Today's case is easier, because the exclusivity clauses of the Commodity Exchange Act are at least arguably there for the benefit of the futures markets. Too, if the SEC is right that IPs are not futures, then the futures markets not only must suffer competition with their existing contracts but also would be forbidden to trade IPs themselves. The CME and the CBOT consequently are proper parties to invoke judicial review.

Second, the futures markets lodged with the court a lengthy report the CFTC submitted to the Senate Committee on Agriculture, Nutrition and Forestry explaining its position that it (and not the SEC) has jurisdiction of IPs. The stock exchanges ask us to strike this report because it is not part of the SEC's administrative record. They also want us to strike from the appendix affidavits of Todd E. Petzel that were prepared after the SEC's decision. We deny these motions. The CFTC's report to the Senate is a public document, which the court would be free to consult whether or not anyone had supplied it; lodging simply reduces the workload of the court's librarian. The Petzel affidavits, by contrast, are case-specific documents that may be presented only if part of the administrative record. *Wisconsin Electric Power Co. v. Costle*, 715 F.2d 323, 326-27 (7th Cir. 1983); cf. *Edison Electric Institute v. OSHA*, 849 F.2d 611, 623 n.16 (D.C. Cir. 1988). They are. Although prepared after the SEC's decision, they were submitted to that agency in support of the futures markets' request for a stay. The stock exchanges asked the SEC to strike them; it took no action on that request. So the affidavits entered the administrative record and may be included in the record here, for what they are worth. *Edison Electric*; see also *Association of Pacific Fisheries v. EPA*, 615 F.2d 794, 811-12 (9th Cir. 1980) (Kennedy, J.).

Third, the SEC asks us to dismiss one of the petitions for review, No. 89-1538. The futures markets filed a petition the instant the SEC voted at a public meeting on

March 14 to approve the trading of IPs. They filed additional petitions after the SEC issued its orders on April 11. Section 25(a)(1) of the '34 Act, 15 U.S.C. §78y(a)(1), which supplies this court's jurisdiction, authorizes review of "a final order of the Commission entered pursuant to this chapter". The petition shall be filed "within sixty days after the entry of the order". The Commission's Rules of Practice define "entry" as the date the order is adopted, reflected by its caption. Rule of Practice 22(k), 17 C.F.R. §201.22(k). Until the Commission has "entered" an "order", there is nothing to review. There is a big difference between a vote and an order. Only the order gives legal effect to the SEC's vote.

The futures markets contend that the vote is reviewable because the stock exchanges could have started to trade IPs immediately thereafter, and they refer to *ITT World Communications, Inc. v. FCC*, 621 F.2d 1201 (2d Cir. 1980), which accepted jurisdiction of a petition filed prior to the written order. The FCC's decision in *ITT* went into force before entry of a written document; bound by the decision, ITT, as the party being regulated, needed to file a petition to obtain a stay. The SEC's vote did not produce an immediately effective order. It did not require the futures markets to take any action. The vote (without the order) had no effect on the futures markets different in kind from a refusal (for the time being) to take action against their competitors. To see this, suppose that the stock exchanges had started trading IPs forthwith, and the SEC had done nothing. Inaction would be neither final nor reviewable, for the reasons given in *Delta Options*. The vote of March 14 was at most a clue that if the stock exchanges were to move aggressively, the SEC would not act. Petition No. 89-1538 is dismissed for want of a reviewable order.

III

A

A futures contract, roughly speaking, is a fungible promise to buy or sell a particular commodity at a fixed date

in the future. Futures contracts are fungible because they have standard terms and each side's obligations are guaranteed by a clearing house. Contracts are entered into without prepayment, although the markets and clearing house will set margin to protect their own interests. Trading occurs in "the contract", not in the commodity. Most futures contracts may be performed by delivery of the commodity (wheat, silver, oil, etc.). Some (those based on financial instruments such as T-bills or on the value of an index of stocks) do not allow delivery. Unless the parties cancel their obligations by buying or selling offsetting positions, the long must pay the price stated in the contract (e.g., \$1.00 per gallon for 1,000 gallons of orange juice) and the short must deliver; usually, however, they settle in cash, with the payment based on changes in the market. If the market price, say, rose to \$1.50 per gallon, the short would pay \$500 (50¢ per gallon); if the price fell, the long would pay. The extent to which the settlement price of a commodity futures contract tracks changes in the price of the cash commodity depends on the size and balance of the open positions in "the contract" near the settlement date. When the contract involves financial instruments, though, the price is fixed by mechanical computation from the instruments on which the contracts are based. See *Leist v. Simplot*, 638 F.2d 282, 286-87 (2d Cir. 1980) (Friendly, J.), affirmed on other grounds under the name *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982); Philip McBride Johnson & Thomas Lee Hazen, 1 *Commodities Regulation* §§ 1.03—.04, 1.10 (2d ed. 1989); Bryan Byrne, Jr., *The Stock Index Futures Market* (1987).

A security, roughly speaking, is an undivided interest in a common venture the value of which is subject to uncertainty. Usually this means a claim to the assets and profits of an "issuer". Shares of stock entitle their holders to receive dividends and payments on liquidation (or a change in corporate form), see *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); bonds and other debt instruments promise interest plus a balloon payment of principal at the end. Unusual interests such as rights in orange

groves still may be "securities" if they represent a pro rata share of a variable pool of earnings. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). See generally Louis Loss & Joel Seligman, 2 *Securities Regulation* 926-89 (3d ed. 1988).

Securities usually arise out of capital formation and aggregation (entrusting funds to an entrepreneur), while futures are means of hedging, speculation, and price revelation without transfer of capital. So one could think of the distinction between the jurisdiction of the SEC and that of the CFTC as the difference between regulating capital formation and regulating hedging. Congress conceived the role of the CFTC in that way when it created the agency in 1974 to assume functions that had been performed by the Department of Agriculture but which were no longer thought appropriate for that Department as futures markets expanded beyond commodities into financial instruments. See *GNMA Options* for a recap of the history. Unfortunately, the distinction between capital formation and hedging falls apart when it comes time to allocate the regulation of options.

A call option is a promise by the writer to deliver the underlying instrument at a price fixed in advance (the "strike price") if the option is exercised within a set time. The buyer pays a price (the "premium") in advance for the opportunity; the writer may or may not own the instrument he promises to deliver. Call options are written "out of the money"—that is, the exercise price exceeds the market price at the outset. The writer will make money if by the time the option expires the market price is less than the strike price plus the premium (plus the interest earned on the premium in the interim); the buyer of the option hopes that the market price will rise above the strike price by enough to cover the premium, the time value of money, and the transactions costs of executing the option. Options play valuable roles in price-discovery, and they also allow the parties to adjust the net riskiness of their portfolios. Writers of call options reduce the risk they bear if the market falls while limiting

gains if the market rises; buyers hope for large proportional gains if the market rises while accepting the likelihood that the options will turn out to be worthless. Options are side deals among investors, which do not augment an entrepreneur's coffers (except to the extent greater liquidity and opportunities to adjust risk increase social marginal propensity to invest). Dwight M. Jaffee, *The Impact of Financial Futures and Options on Capital Formation*, 4 J. Futures Markets 417 (1984). Unlike financial and index futures, options call for delivery of the underlying instrument—be it a share of stock or a futures contract.

The SEC consistently has taken the position that options on securities should be regulated as securities. For some years the CFTC maintained that options on securities should be regulated as futures because options are extrinsic to capital formation and because it is almost always possible to devise an option with the same economic attributes as a futures contract (and the reverse). Matters came to a head in 1980, when both agencies asserted jurisdiction over options on securities based on pools of notes. The Government National Mortgage Association (GNMA) sold pass-through certificates representing proceeds of mortgage notes, and persons started writing options on them to allow hedging against movements in interest rates. The SEC observed that options written on securities are securities under §3(a)(10) of the '34 Act; indeed the SEC contended that because options are securities it should regulate all options. The CFTC countered that options on financial instruments are futures under §4c(b) of the CEA, 7 U.S.C. §6c(b), and added that because its jurisdiction is exclusive, it is the sole lawful regulator. When the SEC allowed stock exchanges to start trading GNMA options, the futures markets sought review in this court and the CFTC howled bloody murder.

While the case was pending, the agencies reached a pact, which the SEC calls the Shad-Johnson Agreement and the CFTC calls the Johnson-Shad Agreement. (John Shad was the SEC's Chairman at the time, and Phillip

Johnson the CFTC's.) This Accord (as we shall call it to avoid offending either agency) provided that jurisdiction over options follows jurisdiction over the things on which the options are written. So the SEC received jurisdiction of options on securities, while the CFTC got jurisdiction of options on futures contracts. Things were not quite done, though, because we held in *GNMA Options* that the agencies could not alter their jurisdiction by mutual agreement. 677 F.2d at 1142 n.8. Starting from the proposition that options on GNMAs are both securities and futures, we held that the CFTC's jurisdiction is exclusive in light of 7 U.S.C. §§ 2 and 2a.

Congress then enacted the Accord almost verbatim, producing the explicit reference to options in §3(a)(10) of the '34 Act, the SEC savings clause in §2a(i) of the CEA, and a small change in 7 U.S.C. §6n to implement an understanding about pools. The legislature thought that this Accord would resolve things and restore a regime in which the SEC supervises capital formation and the CFTC hedging. See S. Rep. No. 97-384, 97th Cong., 2d Sess. 21-24 (1982); H.R. Rep. No. 97-565, 97th Cong., 2d Sess., Part I at 38-40 (1982); H.R. Rep. No. 97-626, 97th Cong., 2d Sess., Part II at 3 (1982); 128 Cong. Rec. 24910 (1982) (Rep. De La Garza); Loss & Seligman, 2 *Securities Regulation* at 1064-80; Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 Albany L. Rev. 741 (1983).

The legislation implementing the Accord left in place the premise on which *GNMA Options* was founded: if an instrument is *both* a security and a futures contract, then the CFTC's jurisdiction is exclusive. Section 2a(ii) has no other possible meaning. Like many an agreement resolving a spat, the Accord addressed a symptom rather than the problem. Options are only one among many instruments that can have attributes of futures contracts as well as securities. Financial markets work best when they offer every possible combination of risk and return—a condition financial economists call "spanning"—so that in-

vestors can construct a portfolio to each need and taste. Exchanges and professional investors therefore continually devise financial products to fill unoccupied niches. See Dennis W. Carlton, *Futures Markets: Their Purpose, Their History, Their Growth, Their Successes and Failures*, 4 J. Futures Markets 237 (1984); William L. Silber, *Innovation, Competition and New Contract Design in Futures Markets*, 1 J. Futures Markets 123 (1981). These products are valuable to the extent that they do *not* match the attributes of instruments already available. New products, offering a new risk-return mixture, are designed to depart from today's models.

Which means that the dispute of 1980-82 about options will be played out—is being played out—about each new instrument. Today's case repeats the conflict. Other novel instruments are being handled by regulation. For example, on July 17, 1989, the CFTC adopted rules exempting from its regulation certain hybrid instruments combining equity or debt with payments based on the price of commodities. 17 C.F.R. Part 34, 54 Fed. Reg. 30684 (1989). Only merger of the agencies or functional separation in the statute can avoid continual conflict. Functional separation is hard to achieve (new instruments will appear at any border). The SEC favors merger; it has asked Congress repeatedly for jurisdiction over all products (including stock-index and financial futures) based on securities, which would relegate the CFTC to its original role as superintendent of commodities futures. The CFTC has so far defended its position, in part with the argument that multiple regulatory bodies allow greater competition and experimentation—a new product can reach market if either agency approves the variant within its domain. See Daniel R. Fischel, *Regulatory Conflict and Entry Regulation of New Futures Contracts*, 59 J. Business S85 (1986); Ronald W. Anderson, *The Regulation of Futures Contracts Innovations in the United States*, 4 J. Futures Markets 297 (1984).

Unless Congress changes the allocation of jurisdiction between the agencies, the question a court must resolve

is the same as in *GNMA Options*: is the instrument a futures contract? If yes, then the CFTC's jurisdiction is exclusive, unless it is also an option on a security, in which case the SEC's jurisdiction is exclusive. So long as an instrument is a futures contract (and not an option), whether it is also a "security" is neither here nor there. Still, if IPs really are "stock" they almost certainly are not "futures contracts", so the inquiries aren't so distinct as the statutes imply.

B

From the perspective of the long, IPs look like an interest in a portfolio of stock. IPs last indefinitely (except for the chance that a long may be cashed out involuntarily on the CBOE), may be sold like stock or used to secure margin and other loans, change in value with the market, and pay dividends. IPs lack other common attributes of stock: they do not confer voting rights and are not "certificated"; owners of IPs receive dividend-equivalent payments quarterly, not when the firms pay dividends. We need not debate whether these differences come to anything, for they pale beside the larger difficulties in calling IPs "stock". The greatest is that IPs are not stock *in* anything. There isn't an issuer—which the SEC emphasized when concluding that the Investment Company Act is inapplicable, 54 Fed. Reg. at 15289-90. Stock is an equity interest in an issuer, the residual claim to the profits of a venture. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). *Landreth* rejected the "sale-of-business doctrine" because the owner of 100% of the equity interest in a firm still owns "stock".[2] Pur-

[2] Attributes such as transferrability, appreciation, and votes are useful to distinguish "real stock" from pieces of paper labeled "stock" that do not convey the ordinary interests of equity. *Landreth*, 471 U.S. at 686. Such documents had been issued in *Forman* as part of a residential co-op development. Transferrability and the like are not talismans, however, but only ways to iden-

(Footnote continued on following page)

chasers of IPs don't own equity, directly or indirectly; they don't have a claim to the proceeds and liquidating distribution of a business; there isn't an underlying pool of assets; there is only a "short" on the other side. The absence of an issuer—IPs don't carry votes because they don't have anything to do with equity—tells all. There is no common venture, not even the commonality represented by a mutual fund (which reinvests in real stock and creates the risk that the stakeholder will join Robert Vesco with the kitty).

IPs do not fit comfortably into any of the other pigeonholes of §3(a)(10). A "certificate of interest or participation in . . . any of the foregoing" securities is a security too, but IPs do not represent an "interest or participation" in the stocks in the index; they are based on the value *of* stock without creating a legal interest *in* stock. Perhaps the closest match is the language, part of the Accord in 1982, covering a "privilege on any security . . . or group or index of securities (including any interest therein *or based on the value thereof*)". Then there's the catch-all: "in general, any instrument commonly known as a 'security' ". IPs convey privileges based on the value of an index, and what is "commonly known as a security" changes as new instruments come into use. So there is a basis for drawing IPs within §3(a)(10), even though they do not duplicate a recognized category. See also, e.g., *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967).

Although the SEC found IPs to be securities by looking at the promises made *to* the longs, the CFTC found them to be futures by virtue of the promises made *by* the shorts, a perspective implied by the CEA's references to "contracts . . . for future delivery"—emphasizing the

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[2] *continued*

tify equity claims. Much real "stock" does not trade or appreciate in value, because it is covered by buy-sell agreements. (Closely held firms often provide that stock may be sold only to the firm, and then at a formula price.) It is nonetheless stock, as *Landreth* holds, because it is a real equity claim to a business.

shorts' obligation. Shorts on IPs make the same pledge as shorts on stock-index futures contracts: to pay the value of an index on a prescribed day (the expiration date for the futures contract, the cash-out date for the IP). The short owes this obligation to the clearing house rather than to the long. IPs may be settled by buying or selling an offsetting obligation, after which the clearing house cancels the two on the books, just as with futures contracts. Shorts on IPs must put up more margin than shorts on futures contracts and must make dividend-equivalent payments, but the CFTC did not find these differences any more dispositive than the SEC found the IPs' lack of voting rights. Shorts also face an obligation of indefinite duration on the Philadelphia and AMEX IPs, but the CFTC and the futures markets treat this as no more than a prepaid rollover privilege.

Despite the congruence of futures and IPs on the short side, the SEC and the stock exchanges say that both "futurity" and "bilateralism" are missing. According to the SEC, IPs lack "futurity" because an IP is the "present obligation to pay current value". And IPs are not bilateral because the long performs in full by paying up front, although in a futures contract both sides must perform on settlement or expiration.

With respect to bilateralism, the SEC's point is inescapable. With respect to futurity, the SEC is wrong. IPs are no more a "present obligation to pay current value" than are futures contracts. The holder of either an IP or a stock-index futures contract may go to market and trade it; the price necessarily tracks current value. Neither the long on an IP nor the long on a futures contract can compel the short to *pay* current value, however.[3] Both the

[3] The daily cash-out-at-a-penalty feature of the Philadelphia's IP may oblige the short to pay "current" value less 0.5%, but none of the parties to the case suggests that the Philadelphia's product should be treated differently on this account. We therefore do not pursue it. Similarly, we bypass the delivery option in the AMEX IP and the short's opportunity to get out of the CBOE IP, both of which make IPs look more like futures.

futures contract and the IP are settled quarterly (the same dates for both kinds of instrument, except for the CBOE's omission of two of the four dates). The short's obligation is to pay the value of the index *on that date*—which lies in the future to the same extent as the settlement date of any futures contract. Even from the long's point of view, IP and futures contract ultimately look the same. The long pays up front for the IP, but the long on a futures contract *promises* up front to make a defined payment on the settlement date; the difference in the timing of the payment does not affect the fact that valuation comes at the defined future date.

So the IP has futurity but not bilateralism. It looks like a futures contract to the short—except that it is of indefinite duration, carries a dividend-equivalent obligation, and requires higher margin. It looks like a mutual fund to the long—except that it has no voting rights, does not represent any interest in an underlying pool of stock, and may be settled by executing an offsetting transaction. Fact is, it is no less a future than it is a security, and no more. It just doesn't fit. Which is the whole point. It isn't supposed to be just like something else; the IP was designed as a novel instrument so that it could offer attributes previously missing in the market.

The only thing of which we are sure is that an IP is not an option on a security. The AMEX contends that it is a prepaid option, with a premium equal to the full value and an exercise price of zero. The SEC did not accept this contention, writing:

> [W]hile IPs contain some characteristics of stock index options (*e.g.*, the issuance and clearance and settlement features of IPs are analogous to those of stock index options), the Commission believes that IPs predominantly have the attributes of a portfolio of common stock.

54 Fed. Reg. at 15286 n.57. The only "characteristics of stock index options" that either the AMEX or the SEC identified are those introduced by the presence of a clear-

ing house—characteristics that the IP shares with stock-index futures to the last detail. Unless we were to say that all futures are also options (they aren't), these features do not make IPs options. The very features that the SEC emphasizes to show that IPs are securities—indefinite duration, payment up front in cash, dividend equivalency, and so on—show that IPs cannot be options. Options are written out of the money, limited in time, and establish a careful balance among premium, strike price, and duration; the writer retains dividends. IPs possess none of these distinguishing features. As the AMEX defines an "option", someone who buys an automobile for cash and drives it away really has obtained an option with a high premium, zero strike price, perpetual duration, and 100% probability of exercise. Words are useful only to the extent they distinguish some things from others; symbols that comprise everything mean nothing. IPs are not options.

C

Having concluded that neither the '34 Act nor the CEA addresses the status of IPs in a straightforward way, the logical thing to do is to defer to the agency's resolution of the problem. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). But which agency? Each claims to be exercising its discretion; each claims entitlement to deference on a subject within its domain.

Although cases frequently say that courts should defer to the judgment of the responsible agency whenever the statute is ambiguous as applied to a subject, e.g., *NLRB v. Hearst Publications, Inc.*, 322 U.S. 111 (1944), this is something of an oversimplification. Ambiguity does not necessarily dictate whether the court or the agency has the dispositive word. Many's the statute that drops a half-resolved dispute in the lap of the courts even though one or more agencies exercise jurisdiction. Think of the antitrust laws, which courts freely construe even though both

the Antitrust Division of the Department of Justice and the Federal Trade Commission may lay claim to greater expertise. When a statute has gaps and uncertainties—the status of all rules—the anterior question is: who is charged with filling the gaps? Often statutes delegate comprehensive powers to agencies, and the meaning of the law is that agencies shall solve novel problems as they arise. Solutions may involve complex and unanticipated adjustments. Courts can be more confident that power has been delegated than that any particular exercise is "right". Deference to the agency's conclusion follows naturally from such a determination, for what Congress wanted to obtain is the judgment of the agency—Congress delegates precisely because it cannot foresee and resolve all problems. See *Chevron*, 467 U.S. at 843-45; *Young v. Community Nutrition Institute*, 476 U.S. 974, 981-84 (1986); *Homemakers North Shore, Inc. v. Bowen*, 832 F.2d 408, 411-12 (7th Cir. 1987); Henry P. Monaghan, *Marbury and the Administrative State*, 83 Colum. L. Rev. 1 (1983). When the agency is the addressee of the statutory command, it takes the leading part in giving structure to the statute; when the court is the addressee, it has the principal role.

When two agencies claim to be the addressees, though, this allocation breaks down. Perhaps a court could say that because the agencies disagree, neither is entitled to deference. Yet disagreement doesn't make the court the recipient of interpretive powers. One or the other agency is still in charge. Courts readily could accept both the SEC's application of the '34 Act to IPs and the CFTC's application of the CEA. Our difficulty is not any logical conundrum in deferring to both agencies when they disagree. It is instead that a dispute about the agencies' jurisdiction is a zero-sum game because of the exclusivity clauses in the CEA.

Any distinction between action under delegated powers and fixing the scope of delegation will break down at the edges, and some recent cases suggest that a court should not try to draw such a line in the first place—one of them

concerning the scope of the CFTC's powers. *CFTC v. Schor*, 478 U.S. 833, 844-46 (1986); see also *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 108 S. Ct. 2428, 2444 (1988) (Scalia, J., concurring); *CSX Transportation v. United States*, 867 F.2d 1439, 1445 (D.C. Cir. 1989) (Edwards, J., dissenting) (suggesting that *Chevron* disallows inquiry into the extent of delegation, although that should be the right question). But even if unambiguous delegation is not a necessary condition of deference, it is an important ingredient in the formula, else it becomes impossible to distinguish statutes such as the Sherman Act from those such as the Clean Air Act, or to conceive where the boundary between court and commission falls. Delegation to agencies is not without its costs to the separation of powers; holding agencies within their delegated scope is an important task in maintaining constitutional structure.[4]

Difficulties in establishing the competence of the agencies and the judicial branch do not influence the outcome of this case, however. We may assume without deciding that even in this jurisdictional dispute, each agency is entitled to leeway in applying its own statute to IPs.

D

If each agency's interpretation of its own statute is entitled to some deference, then the IP is both a security and a futures contract. It has some attributes of both, and all attributes of neither, as we have laid out in excessive detail. Neither characterization can be called wrong.

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[4] See also Cynthia R. Farina, *Statutory Interpretation and the Balance of Power in the Administrative State*, 89 Colum. L. Rev. 452, 502-26 (1989); Richard J. Pierce, Jr., *Two Problems in Administrative Law*, 1988 Duke L.J. 300; Stephen Breyer, *Judicial Review of Questions of Law and Policy*, 38 Admin. L. Rev. 363 (1986); Clark Byse, *Judicial Review of Administrative Interpretation of Statutes*, 2 Admin. L.J. 255 (1988).

The only element of financial futures contracts that is missing is "bilateralism". Yet bilateralism is not essential to a futures contract. *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573 (9th Cir. 1982), held that a contract that imposes performance obligations only on the short may be a futures contract. Co Petro sold interests in gasoline that were designed to look like forward contracts, which under the CEA are not futures contracts. Buyers put down deposits to obtain Co Petro's promise to deliver gasoline on future dates. These contracts could not be traded on any market, but Co Petro promised to pay the investor in cash if the market price should rise (that is, the investor could sell the contract back to Co Petro). The investor risked no more than 95% of his deposit; if the price of gasoline fell, the investor's position would be closed. Thus buyers of Co Petro's contracts performed fully on the date they posted the deposit; thereafter only Co Petro had obligations. Despite that, and despite the fact that the contracts were illiquid, the court of appeals concluded that they were futures contracts because their value depended entirely on the price of the commodity at their expiration date, and they were not formed in contemplation of physical delivery.

The SEC brushes off *Co Petro* and similar cases in district courts as based on the principle that once it smells sulfur (Co Petro may have been a bucket shop), either agency may protect the investor. No such principle may be found in the '34 Act or the CEA, however. An instrument either is or is not a futures contract. If it is, the CFTC has jurisdiction; if it is not, the CFTC lacks jurisdiction; if the CFTC has jurisdiction, its power is exclusive. The SEC's position entails the proposition that if Co Petro Marketing Group, Inc., had approached the CFTC after losing in the Ninth Circuit and applied for permission to trade its gasoline contracts as futures, the CFTC would have had to say no, *on the ground that the contracts are not "contracts . . . for future delivery"* under the CEA. That can't be right.

Perhaps this point will be clearer if we ask what would have happened if the CBOT and CME had approached the CFTC in 1987 (before the Philadelphia Stock Exchange filed its proposal with the SEC) seeking permission to trade IPs. When we asked the SEC's Solicitor during oral argument whether the CFTC could have granted such an application, he said yes—largely on the ground that granting the application would have introduced a new product with benefits for investors. When we persisted with the question whether the CFTC could grant the identical application, filed by the CBOT and CME in 1989 (after the SEC's decision), the Solicitor said no, on the ground that by 1989 the SEC had asserted jurisdiction. Yet this principle of first-come-first-served finds no support in the '34 Act or the CEA. Either IPs are futures contracts or they aren't. If they are futures contracts, then the CFTC could have approved their trading in 1987 (as the Solicitor agreed); if IPs were futures in 1987, they are futures today, and the CFTC still may approve their trading. But if the CFTC may approve their trading because they are futures contracts, then the CFTC's jurisdiction is exclusive.

Doubtless such a decision gives the futures markets the opportunity to block competition from an innovative financial product. The SEC's order, and its brief in this court, casts much of the argument in the form: "The IP is a desirable product; the futures markets have not proposed to trade IPs; if IPs are futures then the CFTC's jurisdiction is exclusive and IPs won't exist, which would be regrettable; therefore IPs are not futures." Everything works until the "therefore". Whether IPs are futures can't depend on who first proposed to trade them, or on whether anyone does. We doubt the premise of the SEC's argument as well as its conclusion, for *if* IPs are useful to investors, then someone will offer them—if not the CBOT and CME, then a market in New York, or Kansas City, or Tokyo. The CBOT and CME will be compelled to follow or they will lose business. There are too many futures exchanges to suppose that a conspiracy could sup-

press a beneficial financial instrument, cf. *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 590 (1986). But whether or not a futures market will seek to trade a financial product does not change the nature of that product, and both the '34 Act and the CEA define coverage by the attributes of the *instrument* rather than by the identity of those who own or trade it. This is the central message of *Landreth*, which at the SEC's urging rejected the "sale of business doctrine" precisely because that doctrine disregarded the characteristics of the financial instrument in order to go straight to the question whether certain persons needed the protection of the law—that is to say, whether coverage was a good idea.

From time to time, the Supreme Court has looked to the purposes of the '34 Act to define "securities", usually with a view to enlarging the definition. (The exception is *Marine Bank v. Weaver*, 455 U.S. 551 (1982).) With the SEC urging it on, the Court has drawn in orange groves covered by joint harvesting contracts, *W.J. Howey*, leaseholds in land near oil wells, *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), and other unusual instruments that have some (but far from all) attributes of conventional securities. Obviously the SEC does not ask us to abandon this approach—for itself. It demands, however, that we apply *strictissimi juris* to the CEA, to hold that only an instrument with *every* attribute of a conventional futures contract may be one. Why? If the interpretive approach is proper for the securities acts, it is no less proper for the futures acts. It has been employed under both statutes—not only in *Co Petro* but also in redefining futures contracts to omit the delivery obligation. Recall the statutory scope of the CEA: contracts "for future delivery". Commodity futures contracts may be settled by delivery; financial futures contracts are settled exclusively in cash. One might have thought the prospect of "future delivery" the *sine qua non* of a "futures" contract. Yet no one, not even the SEC, doubts that a contract may be a futures contract even though it provides for cash

settlement. If delivery is not essential, then the "traditional" elements of futures contracts are not invariable ingredients of the CFTC's jurisdiction.

Perhaps the SEC wants us to put a thumb on the scales, enlarging the category "securities" while shrinking the category "futures" because of the exclusivity clauses in the CEA: if both categories expand, then the SEC's jurisdiction shrinks. We do not conceive it our function, however, to invent counterweights to statutes; judges should be interpreters rather than sappers and miners. As we said in *GNMA Options*, 677 F.2d at 1161, "[o]ur task should not reflect a value judgment as to which of the competing agencies is best equipped to regulate these [products]."

To the extent instrumental arguments influence the coverage of the laws, they do not necessarily cut for the SEC. The futures markets' reply brief invites us to imagine a "Wheat Index Participation" (WIP) having the same characteristics as the IP except that it is based on an index of wheat prices rather than of stock prices. The buyer would pay cash for the WIP and be able to trade it freely; on a date identical to the expiry of the wheat futures contracts, the writer could be required to pay cash measured by the value of the wheat index. According to the SEC, such an instrument would not be a futures contract because it would lack both futurity and bilateralism (and we would agree on the latter point). So the CFTC could not allow it to be traded, no matter how valuable participants in the market might find it. On the other hand, the WIP certainly would not be "stock" and probably would not meet the criteria for being a "security" of any kind. So the SEC could not allow it to be traded on stock exchanges (anyway, the WIP would be a duck out of water on the AMEX!). We could escape from such silliness by reaching the logical conclusion that a WIP would be a futures contract. Yet if the WIP is a futures contract, it is hard to avoid the conclusion that the IP is one, too.

The petition for review in No. 89-1538 is dismissed for want of jurisdiction. The Investment Company Institute's petition, No. 89-2012, presents questions that we need not reach in light of our disposition of the futures markets' claims. On petition Nos. 89-1763 and 89-1786, the SEC's orders approving the applications of the stock exchanges and the OCC are set aside.

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APPENDIX B

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-26709; File Nos. SR-Phlx-88-07; SR-Amex-88-10; SR-CBOE-88-09)

Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; American Stock Exchange, Inc.; Chicago Board Options Exchange, Inc.; Order Approving Proposed Rule Changes Relating to the Listing and Trading of Index Participations

I. Introduction

On February 29, April 18, and May 26, 1988, the Philadelphia Stock Exchange, Inc. ("Phlx"), the American Stock Exchange, Inc. ("Amex"), and the Chicago Board Options Exchange, Inc. ("CBOE") (collectively "exchanges"), respectively, submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] proposed rule changes to list for trading market basket products designated as index participations ("IPs").

The proposed rule changes were noticed in Securities Exchange Act Release Nos. 25495 (March 23, 1988), 53 FR 10311; 25664 (May 5, 1988), 53 FR 16805; and 25799 (June 13, 1988), 53 FR 22754. The exchanges subsequently submitted amendments to their proposed rule changes.[3] The Commission received 25 comment letters relating to the proposed rule changes.[4]

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[1] 15 U.S.C. §78s(b)(1) (1982).

[2] 17 C.F.R. §240.19b-4 (1988).

[3] These Amendments have been noticed for public comment in the *Federal Register*. *See* notes 6, 7, 9, 10, 14, and 17 *infra*.

[4] *See* notes 22-28 and 30-31, *infra* and accompanying text.

II. Background and Description of the Products

A. Terms of the Contracts

An IP is a present interest in the current value of a portfolio of stocks. IPs are of indefinite duration, and entitle holders to cash payments equivalent to a proportionate share of any regular cash dividends paid on the component stocks of the underlying equity portfolio. Investors buying and selling IPs can realize profits or limit losses on their investment by entering into an offsetting sale or purchase of an IP in a closing transaction and thereby receive or make payment of the difference between the cost of the opening and closing transactions. Alternatively, investors purchasing IPs may elect instead to realize profits or limit losses on their investment through exercising a cash-out privilege[5] which is available, depending on the IP, on a daily, quarterly, or a semi-annual basis.

The dates on which IPs purchasers may obtain the full index value upon exercise of the cash-out privilege are designated as cash-out times. Excluding the Phlx's daily cash-out alternative, the cash-out time for each quarter or semi-annual period, depending on the IP, will be determined and made public by each Exchange before the beginning of such period.

The Phlx IP, called the Cash Index Participation ("CIP"), permits holders to exercise the cash-out feature on a daily basis in addition to the designated quarterly cash-out time.[6]

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[5] *See* discussion on p. 6 *infra*.

[6] The CIP, when first proposed by the Phlx, provided for a quarterly cash-out only. Subsequently, on September 26 and October 11, 1988, the Phlx submitted Amendments Nos. 2 and 3, respectively to its proposed rule change. In general, these amendments would permit CIP holders to exercise the cash-out feature on a

(Footnote continued on following page)

A CIP holder that exercises the cash-out feature on any day other than the designated quarterly cash-out time will receive 99.5% of the underlying portfolio's value. The Phlx notes that the .5% differential subtracted from the index value received by such CIP holders is a fee that reflects the substantial benefit to CIP holders of daily cash-out, and that CIP holders may avoid the discount by closing out their positions for cash in the market or by cashing out at a regular quarterly cash-out date.

The Amex product is termed the Equity Index Participation ("EIP"). EIPs, as originally proposed by the Amex, enabled purchasers to exercise a cash-out privilege on a quarterly basis. On October 27, 1988, the Amex submitted an amendment to permit EIP holders to receive either cash or physical delivery of shares of the component stocks of the S&P 500 Index and the Major Market Index under specified circumstances.[7] More specifically, the holder of one or more delivery units[8] that has not chosen to exercise the cash-out privilege has the right to obtain on each delivery time, which

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[6] *continued*

daily as well as quarterly basis. To exercise the daily cash-out feature an IP holder must submit notice of this exercise by 4:15 p.m. The IP holder would receive a cash payment equal to 99.5% of the index value as of the close of business the following day. The Phlx has tentatively determined to establish the quarterly cash-out time to coincide with the expiration of the leading stock index futures contracts [*i.e.* the opening of trading on the third Friday of March, June, September, and December ("Expiration Friday")]. *See* Securities Exchange Act Release No. 26174 (October 13, 1988), 53 FR 40814.

[7] *See* Securities Exchange Act Release No. 26243 (November 2, 1988), 53 FR 45407.

[8] A delivery unit is defined as the minimum number, as specified by the Amex, of EIPs of a particular class that must be held in an individual account by a holder at the time of exercise of the delivery privilege, or that must be maintained as a short position in an

(Footnote continued on following page)

coincides with the quarterly cash-out time, the physical delivery of the proportionate number of shares of each stock comprising the underlying index, subject to certain conditions. A delivery fee established by the Amex will be charged to EIP holders taking physical delivery of the component stocks.

Under the Amex proposal, exercise notices requesting physical delivery of one or more delivery units will be assigned first, on a random basis, to those short EIP positions that have notified the Options Clearing Corporation ("OCC") of a desire to make physical delivery. If the number of delivery units for which holders have requested physical delivery exceeds the number of units made available for delivery by persons with short EIP positions, then an Amex-designated physical delivery facilitator will assume responsibility for delivering the physical shares with respect to such excess number of units.[9]

The CBOE product, called the Value of Index Participation ("VIP"), differs from both the Phlx CIP and the Amex

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[8] *continued*

equivalent account by a person who notifies OCC of a desire to make physical delivery of securities to a holder if assigned an exercise. The Amex has tentatively established the delivery unit as 50,000 EIPs per unit for the S&P 500 Index and 25,000 EIPs per unit for the XMI. The Amex believes that permitting physical delivery of units below these levels would be impractical because of the minute number of shares of individual stocks that would be deliverable. If the Amex intends to modify the minimum number of EIPs that constitute a delivery unit, then the exchange must submit a separate proposed rule change for Commission approval.

[9] The Amex's Amendment No. 2 to its EIP filing noted that the physical delivery facilitator could deliver shares out of inventory, buy shares at the opening on the cash-out date, or borrow shares. However, in order to ameliorate any concerns regarding the facilitator's advance knowledge of physical delivery unit imbal-

(Footnote continued on following page)

EIP in that it allows VIP sellers, as well as purchasers, to exercise a cash-out privilege on a semi-annual basis. A person with a short VIP position desiring to exercise the cash-out privilege originally was required to pay a premium of 1% of the index's value. The CBOE eliminated this charge, however, in an amendment filed on November 1, 1988.[10] The Exchange believes that the existence of a cash-out privilege for holders of both long and short positions will cause the price of VIPs to trade more closely to the value of the underlying portfolio because it will allow a hedged short VIP holder an alternative to reversing his position by purchasing the VIP at the current market price and selling the underlying equities.

Notice of exercise of the IP cash-out privilege must be provided by an IP purchaser on or before a time specified and made public by the Exchange on which the IP is traded. The exchanges have determined to establish and make public the cut-off time for the submission of notices of exercise of an IP cash-out privilege before the beginning of each quarterly or semi-annual cash-out time. At the present time, the exchanges have established an exercise cut-off time of the close of trading on the day before the quarterly or semi-annual cash-out time (*i.e.* 4:15 p.m. on the Thursday before

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9 *continued*

ances, the Amex submitted an additional amendment under which the facilitator may satisfy such imbalances only by delivering component shares purchased at the opening on the cash-out date. This facilitator will be compensated out of proceeds received from shorts who have been assigned exercise notices. Initially, the Amex contemplates designating only one facilitator per EIP class and notes the facilitator may be the specialist unit for that class of EIPs. *See* Securities Exchange Act Release No. 26355 (December 13, 1988), 53 FR 51181.

10 *See* Securities Exchange Act Release No. 26257 (November 7, 1988), 53 FR 45833. This amendment also changed the cash-out feature from a quarterly to a semi-annual cycle.

the quarterly or semi-annual cash-out time).[11] An exercise notice may be tendered to the OCC only by the OCC clearing member in whose account the IP is carried. Upon exercise of the quarterly or semi-annual cash-out privilege an IP purchaser may obtain at the cash-out time the IP index value based on the opening trades of the portfolio's component stocks on the next day.[12]

Pursuant to the exchanges' proposed rules, each member organization will establish fixed procedures for the allocation of IP exercise notices assigned to a short (or long also in the case of CBOE VIPs) position in IPs in such member organization's customers' accounts. Such allocation shall be made on either a "first-in, first-out" basis, automated random selection basis that has been approved by the exchanges, or on a manual random selection basis. Each member organization will inform its customers in writing of the method it uses to allocate exercise notices to its customers' accounts, explaining its manner of operation and the consequences of that system.

Pursuant to the exchanges' proposed rules, all bids and offers made on the trading floor for IPs will be deemed to be for one unit of trading unless a specified greater number of IPs is expressed. A bid or offer for more than a unit of trading of IPs will be deemed to be for the amount thereof

[11] If the exchanges intend to modify the exercise cut-off time they must submit separate proposed rule changes for Commission approval pursuant to Section 19(b)(2).

[12] A CIP holder exercising the daily cash-out privilege on a day other than the quarterly cash-out time receives the value of the portfolio at the close of the next trading day, less the .5 percent exercise fee described above.

or a smaller number of units of trading of IPs. The unit of trading in IPs shall be 100 IPs unless otherwise designated by the Exchange.[13]

The exchanges have reserved the right, in the event of extreme IP trading inactivity or under exceptional circumstances, to require that purchasers and sellers settle their IP contracts at the closing index value determined by a designated cash-out time, upon one year's prior notice to the public.

B. Portfolios Underlying the Proposed Index Participations

1. Composition, Calculation and Adjustment

The exchanges contemplate trading IPs on a variety of underlying portfolios, most of which are relied upon as well-established and widely-disseminated market indicators or market segment indicators, and some of which are new. The Phlx has designated two underlying portfolios for CIP trading: a broad-based portfolio designed by the Exchange ("Blue Chip" Index) and the Standard & Poors 500 ("S&P" 500) portfolio.[14]

The Blue Chip CIP is an IP based on a price-weighted portfolio composed of 25 highly capitalized listed common stock issues representing primarily industrial corporations,

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[13] If the exchanges intend to modify the unit of trading from 100 IPs they must submit separate proposed rule changes for Commission approval.

[14] Originally, the Phlx proposed trading a Stock Market CIP that was based on a 100 stock portfolio developed by the Exchange and was designed to track closely with the S&P 500. On August 23, 1988, the Phlx submitted Amendment No. 1 to the filing in which it withdrew its proposed Stock Market CIP and indicated that it would trade a S&P 500 CIP in its place. *See* Securities Exchange Act Release No. 26058 (September 2, 1988), 53 FR 35247.

and which is designed to replicate the performance of the Dow Jones Industrial Average ("DJIA"). Each Blue Chip CIP will represent 1/100 (the multiplier) times the value of the portfolio, and each S&P 500 CIP[15] will represent 1/10 (the multiplier) times the value of the portfolio. The standard unit of trading in such CIPs will be 100 CIPs, and bids and offers will be expressed in decimals. The Exchange expects to establish a starting Blue Chip CIP portfolio value of approximately 2000, so that each Blue Chip CIP would be priced at approximately $20.00, and each Blue Chip CIP trading unit would be priced at approximately $2,000. The value of the portfolio will be adjusted to account for stock splits, stock dividends, and extraordinary cash dividends. The value of the portfolio will not be adjusted for regular cash dividends paid out to CIP holders. If the character of any stock in the portfolio materially and substantially changes on the account of delisting, merger, acquisition, or otherwise, the Exchange will replace such stock with another stock which possesses similar characteristics so as to retain the integrity and representativeness of the portfolio.

The Amex EIPs will be based on the Major Market Index ("XMI")[16] and the S&P 500.[17] The XMI is a broad-based

[15] *See* Securities Exchange Act Release No. 19907 (June 24, 1983), 48 FR 30814 for a detailed description of the S&P 500 Stock Index. As of December 6, 1988, the closing index value for the S&P 500 was 277.58. Thus, each S&P 500 CIP would be priced at $27.75, and each S&P 500 trading unit would be priced at $2,775.

[16] *See* Securities Exchange Release Nos. 19610 (March 17, 1983), 48 FR 12486; 19709 (April 27, 1983), 48 FR 20179 for a detailed description of the XMI.

[17] The Exchange originally proposed to trade EIPs on the XMI and the Institutional Index ("XII"). On July 21, 1988, however, the Exchange submitted to the Commission Amendment No. 1 to File No. SR-Amex-88-10 to trade EIPs on the S&P 500 rather than on the XII. *See* Securities Exchange Act Release No. 25942 (July 25, 1988), 53 FR 28929.

price-weighted portfolio developed by the Amex, and is comprised of 20 highly capitalized issuers. Each XMI EIP will represent 1/10 (the multiplier) times the portfolio's value,[18] and the standard unit of trading in such EIPs will be 100 EIPs. Bids and offers for EIPs will be quoted in decimals.

The CBOE VIPs are based on the capitalization-weighted CBOE 50 and CBOE 250 portfolios[19] developed and maintained by the Exchange, and the S&P 500 Index, calculated and maintained by Standard and Poor's Corporation. Each CBOE VIP will represent 1/10 (the Index multiplier) times the Index value,[20] and the standard unit of trading will be 100 VIPs. Bids and offers for VIPs will be quoted in fractions of 1/8 of a point.

2. Publication

Publication of the values underlying the IPs will occur at two levels.[21] First, the exchanges will make public the component portfolios they use for calculating the value of their participations. This is necessary to provide market profes-

[18] As of December 6, 1988 the closing index value for the XMI was approximately 423. Thus, each XMI EIP would be priced at $42.30, and each XMI EIP trading unit would be priced at $4,230.

[19] *See* Letter from Jonathan G. Katz, Secretary, SEC to Dr. Paula Tosini, Director, Division of Economic Analysis, CFTC, dated April 22, 1988 for a detailed description of both the underlying CBOE 50 and CBOE 250 portfolios.

[20] As of December 6, 1988 the closing value for the CBOE 250 was approximately 248. Thus, each CBOE 250 VIP would be priced at $24.80, and each CBOE VIP trading unit would be priced at $2,480.

[21] Publication and dissemination of the values of the portfolios underlying IPs will help to ensure the maintenance of a fair and orderly market in the product consistent with the goals of Section 11A(a)(1) of the Act and to reduce the possibility of fraudulent or manipulative trading involving the IPs. *See* 15 U.S.C. § 78f(b)(5) (1982).

sionals, institutions, and other public investors a basis for relating the value of these participations to their own stock positions, and for maximizing the utility of the participations. The Phlx, Amex, and CBOE currently publicize the means by which they compute values of the portfolios underlying their participations (*i.e.* summation of share prices divided by a specific divisor, times the multiplier).

Second, in addition to the real-time computation of underlying portfolio values that will be the subject of index participation trading, those values will be widely disseminated. Because products related to the portfolios underlying the Amex EIP, the CBOE VIP, and the Phlx S&P 500 CIP previously have been approved for trading, those values are already widely disseminated. Additionally, the Phlx has retained Bridge Data, Inc. to compute and perform all necessary maintenance of the Blue Chip CIP. Pursuant to Phlx Rule 1003B, updated underlying portfolio values will be disseminated and displayed by means of primary market prints reported over the Consolidated Last Sale Reporting System and the facilities of the Options Price Reporting Authority. The value of the underlying portfolios will also be available on broker-dealer interrogation devices to subscribers of the CIPs information.

III. Comments Received

The Commission received 25 comment letters in response to its requests for comments on the Phlx, Amex, and CBOE proposed rule changes. Fifteen of the twenty-five comment letters were submitted on behalf of the Commodity Futures Trading Commission ("CFTC"), the Chicago Board of Trade ("CBT"), or the Chicago Mercantile Exchange ("CME"). These letters expressed the belief that the IPs are futures, and therefore that the Commission lacks jurisdiction to ap-

prove the proposed rule changes.[22] In response to these futures industry comment letters the Commission received letters from the Phlx and CBOE, and a comment letter from the Amex, which included opinions of their respective legal counsels, stating that IPs are securities and therefore subject to SEC jurisdiction.[23] Two letters came from the Phlx and Amex that addressed issues related to timing of Commission action on IPs.[24] The Commission also received a letter from the Phlx commenting on Amex Amendment No. 2 to its EIP filing providing for physical delivery,[25] a letter from the Amex responding to this Phlx comment letter,[26] and letters from three investors, two expressing support for immediate approval of CIPs[27] and one suggesting that EIPs

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[22] *See* Letters-to Jonathan G. Katz, Secretary, SEC, from Jean A. Webb, Secretary, CFTC (April 29 ("1st CFTC Letter"), June 1, and July 8, 1988); Thomas R. Donovan, President and Chief Executive Officer, CBT (April 20 ("1st CBT Letter"), June 1, July 8, and November 30, 1988); William Brodsky, President and Chief Executive Officer, CME (April 20 ("1st CME Letter"), May 18, and November 29, 1988); Phillip Stern and Jerrold Salzman, Attorneys, Freeman, Freeman & Salzman on behalf of the CME (August 2, November 7 ("5th CME Letter"), and December 1, 1988 and March 2, 1989). *See also* Letter from Jean A. Webb, Secretary, CFTC, to Shirley E. Hollis, Assistant Secretary, SEC, dated December 13, 1988.

[23] *See* note 34 *infra*.

[24] *See* Letters to Jonathan G. Katz, Secretary, SEC, from Nicholas A. Giordano, President, Phlx (June 29, 1988) ("Phlx letter"); Kenneth R. Liebler, President and Chief Operating Officer, Amex (July 27, 1988) ("Amex letter").

[25] *See* Letter from Nicholas A. Giordano, President, Phlx to Jonathan G. Katz, Secretary, SEC, dated November 23, 1988.

[26] *See* Letter from Gordon L. Nash, Senior Executive Vice President, Legal and Regulatory Affairs, Amex to Jonathan G. Katz, Secretary, SEC, dated February 10, 1989.

[27] *See* Letter from Dennis Weidenbenner to Richard G. Ketchum, Director, Division of Market Regulation, SEC, dated September 29, 1988; Letter from William A. Dodd, Jr. to David Ruder, Chairman, SEC, dated February 24, 1989.

are an unnecessary investment tool.[28] In addition, the Commission received a letter from the Investment Company Institute ("ICI") arguing that IPs are investment company shares and thus must receive relief from the Investment Company Act of 1940[29] before they may be traded on a national securities exchange.[30] Subsequent to the Commission's consideration of the proposed IPs during an open meeting on March 14, 1989, the Commission received a letter on behalf of the ICI arguing that the issuance and trading of IPs create investment companies. In particular, the ICI claimed that the individuals holding long IP positions and short IP positions each constitute an "issuer" under the statutory definition of that term because they are an "organized group of persons."[31]

A. Futures Industry Letters

In general, the CFTC, the CBT, and the CME ("futures commentators") argue that the Commission lacks jurisdiction to authorize IP trading through approval of the Exchanges' proposed rule changes because an IP does not constitute a "security" as defined in Section 3(a)(10) of the Act.[32] In particular, the futures commentators argue that the eco-

[28] *See* Letter from K. Thomas Shipley, Executive Vice President, Charter Investment Group, Inc., to David S. Ruder, Chairman, SEC, dated March 29, 1989.

[29] 15 U.S.C. §§ 80a-1 through 80a-52 (1982).

[30] *See* Letter from Matthew P. Fink, ICI, to Richard G. Ketchum, Director, Division of Market Regulation, SEC, dated December 19, 1988.

[31] See Letter from David M. Miles, Attorney, Fried, Frank, Harris, Shriver & Jacobson on behalf of the ICI, to David S. Ruder *et al.*, Chairman, SEC, dated March 31, 1989. The Commission, in its discretion, determined to consider this comment. 17 C.F.R. 202.6(b).

[32] 15 U.S.C. § 78(c)(1)(j) (1982).

nomic function and purpose of IPs are characteristic of stock index futures rather than stock or index options, and that IPs are therefore subject to the exclusive jurisdiction of the CFTC pursuant to Section 2(a)(1)(B) of the Commodity Exchange Act ("CEA").

The futures commentators suggest several reasons to categorize IPs as stock index futures. First, they argue that both the purchaser and seller of an IP contract have entered into a transaction that may be cashed out at a future date at a price based upon the difference between the price established at the initiation of the contract and some undetermined future price. Second, with the exception of the Amex EIP, the IP contract provides for cash settlement only. Third, while an IP long is entitled to hold his position indefinitely, they argue that essentially the contract has a quarterly expiration—identical to the cycle now applicable for similar futures contracts—due to the quarterly cash-out feature. The futures commentators suggest that this feature is synonymous with an "undated futures market contract." They suggest further that the outcome of effective competition will be that an IP long actually will pay a commission to "roll over" his position, at the time he enters into an IP contract, in the form of higher IP prices. Fourth, there is no apparent option premium paid by an IP long.

The CME, specifically, suggests that, although IPs include two features that may not be immediately recognized as standard features of futures contracts, those features serve the economic equivalent of futures characteristics.[33] First, the short will be required to pay to the long cash payments equivalent to a proportionate share of any regular cash dividends paid on the component stocks of the underlying index. The CME suggests that the concept of a cash payment from

[33] *See* 1st CME Letter at 2-3.

the short to the long, related to measured or theoretical shrinkages in the value of the underlying product, is a feature also found in futures contracts. Second, IPs afford longs the right to select the time at which shorts will be compelled to make cash delivery. The CME notes that this is a standard feature of most physical commodity based futures contracts, and that a futures contract holder generally has a far wider range of options (*e.g.*, the ability to control the exact date, time, and place of the delivery of the commodity to the long).

The Phlx, CBOE, and Amex (the "exchanges") argue that IPs should be viewed as securities as defined in Section 3(a)(10) of the Act.[34] In general, the Phlx and CBOE base their argument on *SEC v. C.M. Joiner Leasing Corp.*[35] in which the Supreme Court emphasized the economic function of instruments in determining whether they constituted securities.[36] Specifically, the Phlx argues that although IPs do not possess all of the familiar characteristics of common stock as described in *Landreth Timber Co. v. Landreth*[37] an

[34] *See generally* Letter from William W. Uchimoto, Acting General Counsel, Phlx, to Richard G. Ketchum, Director, Market Regulation, SEC, dated May 24, 1988, enclosing opinion of Cadwalader, Wickersham and Taft, Phlx legal counsel, regarding SEC jurisdiction over IPs ("Cadwalader Letter"); Letter from Nancy R. Crossman, First Vice President, Legal Services, CBOE to Howard Kramer, Assistant Director, Division of Market Regulation, SEC, dated September 9, 1988, enclosing opinion of Gardner, Carton and Douglas, CBOE legal counsel, regarding SEC jurisdiction over IPs; Letter from Edmund R. Schroeder, Attorney, Lord Day & Lord, Barrett Smith, Amex legal counsel, to Jonathan G. Katz, Secretary, SEC, dated January 13, 1989.

[35] 320 U.S. 344 (1943).

[36] *Joiner Leasing Corp.*, 320 U.S. at 350-51 (1943). The Amex argues that an IP is a security because it is: (1) a call or option on any security or group or index of securities; (2) a certificate of interest or participation in stock; and (3) a right to purchase stock.

[37] 471 U.S. 681, 686-87 (1985). *See* discussion on pp. 28-29 *infra*.

IP does possess most of the characteristics of stock, and purchases and sales of an IP are intended to replicate the economic substance of purchases and sales of an equivalent amount of the underlying stocks.[38]

First, the exchanges argue that IPs entitle holders to receive on a quarterly basis cash payments equivalent to the regular cash dividends declared on the component stocks of the underlying index. Second, the Phlx argues that an IP purchaser will have the ability to pledge or hypothecate his interest in the IP. For example, as a typical provision of customer agreements with a brokerage firm, an investor normally will pledge or hypothecate his interest in the IP, including profits and dividends, as security to the broker for any indebtedness arising in connection with his account or any other indebtedness to the broker. Third, the Phlx argues that IPs will be freely transferable in exchange transactions; thus, IPs will be negotiable in the same sense as exchange-traded equities and equity and non-equity securities options. Fourth, the exchanges argue that IPs will have the capacity to appreciate in value as the securities comprising the underlying portfolio increase in value.

In addition, the Phlx and CBOE assert that, although the purchase and sale of an IP does not constitute the purchase and sale of the underlying shares of stock, the economic substance of transactions in the IP leads to the conclusion that the IP should be viewed as stock for purposes of the definition of security. An IP purchaser or seller will have similar risks and obligations as a person long or short stock. The Phlx notes further that, to the extent these risks and obligations differ from those associated with stock, they resemble a stock index option because of the availability of a cash-out privilege, and because IPs would be issued by the

[38] *See* Cadwalader letter, *supra* note 34, at 5.

OCC rather than a corporation. Moreover, the Phlx argues that the cash settlement feature of IPs should not lead to the conclusion that IPs are more akin to stock index futures than to securities as defined under Sections 3(a)(10) of the Act. The Phlx suggests that in amending the definition of the term "security" to include "any put, call, straddle, option, or privilege on any security . . . or group or index of securities (including any interest therein or based on the value thereof) . . . " Congress explicitly recognized that products which function economically as securities are themselves securities, although they are cash-settled based on the value of underlying securities or indexes.

The Phlx and CBOE argue that IPs are securities because, in addition to possessing the characteristics of stock, IPs may be classified as "an instrument commonly known as a security." In making this determination the Phlx and CBOE rely on the majority view in *Landreth* that the reasonable expectation of investors that they are purchasing securities subject to the securities laws is of particular significance in determining whether an instrument bearing only some of the traditional characteristics of a type of security enumerated in Section 3(a)(10) is a security.[39]

The exchanges suggest that, even if an IP may be considered a commodity under the CEA definition, it is not a "contract of sale for future delivery" for purposes of that Act. In this regard, the exchanges argue that although IPs may possess certain elements characteristic of futures contracts [*e.g.*, standardized terms and the ability of investors to realize profits or limit losses through entry into offsetting sales or purchases and payment of the difference between the purchase (sale) price and the price at which the closing transaction is effected] they lack the most significant element for CEA purposes—the element of futurity.

[39] *Infra* note 46.

The exchanges assert that, unlike stock index futures contracts, a purchase or sale of an IP does not entail a commitment by an investor to buy or sell the value of the underlying index at some time in the future. The exchanges argue that a purchase or sale of the IP involves an actual purchase or sale of the current value of the underlying index, similar to an actual transfer of ownership of the underlying stocks.[40]

In addition, the exchanges note that IPs have other characteristics that differ from futures contracts. First, unlike futures contracts that are listed for trading in different contract months, IPs have a perpetual existence with no fixed expiration date. Second, the IP gives the purchaser a cash-out privilege and the right to receive on a quarterly basis cash payments equivalent to a proportionate share of any regular cash dividends paid on the component stocks of the underlying portfolio. Futures, on the other hand, require settlement upon expiration of the contract and do not grant the right to receive payment of dividends. Third, IPs are less highly leveraged than stock index futures because their proposed margin requirement is 50% of the IP value. In addition, the exchanges note that the IP margin represents a down payment on the purchase price, rather than earnest money or a performance bond, which is the function served by the much lower levels of margin applicable to stock index futures contracts.

B. Proprietary and Other Concerns

In two comment letters regarding Amex's proposed trading of EIPs, the Phlx alleges that the Amex appropriated the CIP design to create the EIP. The Amex filed its EIP pro-

[40] The exchanges note that when an IP is purchased 100% of the instrument's value must be paid. In this regard, even if an IP were margined, an IP purchaser would have to contribute 50% of the transaction's value and convince a lender to loan the remaining 50%.

posal with the Commission shortly after the Phlx, and its original EIP design was virtually identical to the CIP design. The Phlx notes that it has expended a great deal of time, effort, and expense in designing and submitting this new product to the Commission for approval. For example, significant staff time and outside legal counsel fees have been spent in preparing the CIP to be traded. The Phlx believes that allowing the Amex to begin trading an identical product at the initiation of CIP trading would undercut the Phlx's efforts to develop new and innovative products such as CIPs. Further, the Phlx suggests that its CIP product constitutes protectable intellectual or creative work of pecuniary value and is therefore protected under common law principles and statutory law.[41] The Phlx argues both that a vested property right arises with respect to its CIP and that the Amex has infringed its CIP copyright by appropriating entire provisions constituting the vast preponderance of the Phlx's CIP contract specifications and trading rules and presenting them as Amex rules.

For these reasons, the Phlx argues that approval of the Amex's EIP proposal would be inconsistent with Section 6(b)(5), Section 6(b)(8), and Section 11A(a)(1)(C)(ii) of the Act. The Phlx believes that, at the least, it should be provided a 12 to 18 month head start in the introduction of its IP product. In addition to the proprietary product comments, the Phlx argues that the Amex proposal is deficient in discussing the side-by-side trading concerns that could arise from EIP trading.[42] The Phlx suggests that, because Amex pro-

41 *See, e.g.*, International News Service v. Associated Press, 248 U.S. 215 (1918); Standard & Poor's Corp. v. Commodity Exchange, Inc., 683 F.2d 704 (2d Cir. 1982); Board of Trade of the City of Chicago v. Dow Jones & Co., 98 Ill.2d 109, 456 N.E.2d 84 (1983).

42 The Phlx notes that the Amex proposes to trade an EIP on the XMI in addition to the XMI index option currently traded on the

(Footnote continued on following page)

poses to trade EIPs on the Amex's MMI, a portfolio upon which Amex currently lists and trades options, there exists the potential for significant time and place advantages and concomitant inside market information, as well as possible conflict of interest and manipulation concerns.

In response to Phlx's comments regarding Amex's EIPs proposal the Amex submitted a comment letter outlining four major rebuttals to the Phlx letter.[43] First, the Amex suggests that the Commission lacks the authority to adjudicate Phlx's property claims. In this regard, the Amex notes that there is no evidence that Congress intended to provide the Commission with the authority to adjudicate property interests among competing parties because Congress has enacted an elaborate statutory framework for the establish-

[42] *continued*

Amex floor. The Phlx alleges that the trading of an XMI EIP and XMI option should be prohibited because of informational advantages and potential manipulative schemes that could occur as a result of trading these two products on the same floor, side-by-side. The Commission previously has noted that the side-by-side trading of stocks and options on those stocks, while raising regulatory concerns, may be permitted provided adequate audit trail, surveillance information and regulatory safeguards are in place. The Commission has determined that any side-by-side trading concerns (*e.g.*, informational advantages and potential manipulative schemes) are not present with regard to Amex's EIPs for several reasons. First, the Amex will not be trading an individual stock and an option on that individual stock side-by-side. Instead, the Amex will be trading an index option and the equivalent of a portfolio of stocks on its floor. Second, the 20 stocks that comprise the XMI, and therefore directly determine the index's value, have a primary market on the New York Stock Exchange ("NYSE") rather than the Amex. Consequently, any informational advantages associated with trading an XMI EIP on the Amex are minimal. Finally, the Commission is satisfied that existing audit trail data, surveillance information and regulatory safeguards are sufficient to allay any side-by-side trading concerns.

[43] *Supra* note 24.

ment, preservation, and protection of intellectual or creative works and established specific federal agencies (*e.g.*, the U.S. Patent and Trademark Office and U.S. Copyright Office) to administer and enforce these laws. The Amex further notes that the Act provides, neither expressly nor implicitly, that competing property claims among self-regulatory organizations ("SROs") is a proper area of Commission consideration in determining whether to approve specific rule proposals.

Second, the Amex suggests that a Section 19(b) proceeding is inappropriate for adjudicating property rights because such a proceeding would involve the Commission in an exhaustive factual investigation including, but not limited to, a determination of which exchange actually developed the product. The Amex notes that it is prepared to document the fact that it has been actively working for several years on the development of a market basket security and has expended extensive time and resources in so doing.

Third, the Amex suggests that the Phlx CIP is legally protected by neither statutory nor common law principles. The Amex asserts that such a trading instrument is a concept, and thus an idea that can-not (sic) be protected under federal statutory law. The Amex suggests that because it does not seek to utilize any underlying portfolio designed, calculated and disseminated by Phlx as a basis for EIPs trading, and because none of the cases cited in the Phlx letter suggested that duplication or imitation of the idea or the concept on which a commercial enterprise is based would constitute a misappropriation, the Amex has not misappropriated the Phlx product.

Fourth, the Amex suggests that the "fair competition" mandate of Section 11A(a)(C)(ii) of the Act does not authorize the Commission to grant exclusive franchises. The

Amex notes that the cases cited by Phlx in support of its proprietary rights theory recognized that the freedom to imitate and duplicate is of vital importance in a free market economy. In addition, the Amex, citing the experiences of the options markets,[44] argues that Phlx's contention that innovation and commitment to the development of new products will be stifled unless SROs are provided some protected property interest in ideas filed with the Commission is simply erroneous.

IV. Discussion

After careful consideration of the comments received, applicable statutory provisions, and relevant judicial and administrative decisions, the Commission concludes that IPs are securities within the definition of that term in the Act and are not contracts of sale for future delivery, and that therefore such products are subject to the jurisdiction of the Commission. In addition, the Commission concludes that Phlx should not be provided either exclusive trading privileges over IPs or the opportunity to commence IPs trading in advance of other exchanges.

For these reasons and for additional reasons set forth below, the Commission finds that the proposed rule changes relating to the listing and trading of IPs are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, in

[44] The Amex, referring to several Commission releases, notes that the development of new options products has consistently been determined by the Commission not to provide any claim to exclusive trading rights, regardless of which SRO was responsible for initiating the design thereof, for expending funds, time and resources to promote the product, or being the first to file with the Commission.

general, and the requirements of Section 6 and the rules and regulations thereunder, in particular.

A. Jurisdiction

IPs confer the present right to receive the current value of a portfolio of stocks, are of indefinite duration, and entitle holders to payments equivalent to regular cash dividends paid on the underlying stocks. For the reasons set forth below, the Commission concludes that IPs are securities as defined in the Act. Further, the Commission concludes that IPs are not futures contracts subject to regulation under the CEA, and that regulation of IPs as securities is consistent with the purposes underlying both the Act and the CEA.

1. IPs are Securities

The Commission concludes that each of the proposed IP products is a security within the definition of that term under Section 3(a)(10) of the Act. Congress intended that the term "security" be interpreted broadly, and the Supreme Court has, on several occasions, observed that the definition of the term security "is quite broad . . . and includes both instruments whose names alone carry well-settled meaning, as well as instruments of 'more variable character' . . . "[45] It is, thus, well settled that the term "security" is to be interpreted flexibly to encompass new instruments that are similar to, or have the characteristics of, instruments already recognized as securities. In particular, if "economic reality" suggests that such an instrument has the characteristics of instruments that clearly are securities, then it should be defined as a security, even if the instrument does not fit explicitly within the Act's enumeration of specific instruments

[45] *Landreth*, 471 U.S. at 686 (1985) [quoting *Marine Bank*, 455 U.S. at 556 (1982); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)].

that constitute securities.[46] Indeed, in a world of rapid development of new financial instruments, it cannot be expected that Congress would have identified the exact form of all instruments that constitute securities.[47]

[46] *Landreth* (sic) 471 U.S. at 694 (1985); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). Section 3(a)(10), 15 U.S.C. § 78(a)(10) (1982), defines the term "security" as including:

> any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

The Commission notes that the definitions of the term "security" in Section 3(a)(10) of the Act and Section 2(1) of the Securities Act of 1933 ("Securities Act") are virtually identical and have been treated as such by the Supreme Court in decisions dealing with the scope of the term. *See, e.g., Marine Bank*, 455 U.S. at 555 n.3 (1982); United Housing Foundation, Inc. v. Foreman, 421 U.S. 837, 847 n.12 (1975).

[47] While the Commission, in its analysis of IPs, has focused primarily on the portions of the definition discussed in the text, there may be additional bases for concluding that IPs are securities. For example, an IP can be analogized to a receipt for the interests in the securities upon which it is based or to a certificate of deposit for a security. In addition, an analysis of IPs as investment contracts also supports the conclusion that they are securities.

IPs possess the key characteristics of stock. In *Landreth Timber Co. v. Landreth*,[48] the Supreme Court's most recent decision addressing the definition of the term "security," the Court described five characteristic features of stock as: (1) the right to receive dividends; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) the capacity to appreciate in value; and (5) the conferring of voting rights in proportion to the number of shares owned.[49] IPs have all of these characteristics, except voting rights, and have other characteristics of stock as well.

With regard to the *Landreth* characteristics: (1) IP purchasers will be entitled to receive on a quarterly basis cash payments equivalent to a proportionate share of any regular cash dividends paid on the component stocks of the underlying portfolio; (2) because IPs will be freely transferable in exchange transactions, such instruments will be negotiable in the same sense as exchange-traded stock; (3) IP purchasers also will have the ability to pledge or hypothecate their IP interests;[50] and (4) IPs will have the capacity to appreciate in value as the underlying components appreciate in value.[51] The only characteristic cited in *Landreth* that IPs do not provide are voting rights in the stocks comprising the index.

[48] 471 U.S. 681 (1985).

[49] *Id.* at 686-87.

[50] A customer's agreement with his brokerage firm typically provides that an investor normally will pledge his interest in a security, including profits and dividends, as collateral to the broker for any indebtedness arising in connection with his account or any other indebtedness to the broker. In contrast, futures are executory contracts which may not be pledged, except regarding rights to contingent cash payments required by the futures contract.

[51] In addition, insofar as the Amex EIP is concerned, the purchaser or holder of the EIP has the right to receive physical delivery of shares of the component stocks of the Index if he exercises the delivery privilege regarding a sufficient number of EIPs.

This difference is not, by itself, determinative inasmuch as there are many types of securities, including some types of stock, that do not possess voting rights. For example, preferred stock generally possesses either limited or no voting power.[52] Accordingly, the absence of voting rights does not preclude the characterization of IPs as a security.

IPs have two other important characteristics normally associated with stock. First, IPs do not expire. An investor can hold them for an indeterminate time, just as an investor may retain a portfolio of stock indefinitely. Second, purchase requirements and margin treatment for IPs are analogous to stock purchase and margin requirements. As with stock, an IP purchaser pays the full purchase price for his investment at the time of purchase. The IP purchase may be financed by borrowing up to 50% of the IP purchase price just as a stock purchaser may borrow up to 50% of the stock purchase price. Thus, a margin transaction in IPs includes an actual borrowing with the full purchase price then passed through to the IP seller. Accordingly, since IPs so closely resemble a portfolio of stock they should be included within the definition of stock in Section 3(a)(10).

IPs also fall within the term "certificate of interest or participation in" stock. IPs allow investors to replicate a purchase of a portfolio of securities because the value and benefits of IP ownership track the value and benefits of the stocks underlying the portfolio. In addition, IPs are expressly termed "participations."[53]

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[52] As the Court noted in *Landreth*, "various types of preferred stocks may have different characteristics and still be covered by the Acts." *Landreth* , 471 U.S. at 687, n.2 (1985).

[53] While the name of an instrument is not by itself dispositive in determining whether the instrument is included within the statutory definition of the term "security," the name is one factor taken into consideration. *Landreth*, 471 U.S. at 686 (1985); United Housing Foundation v. Foreman, 421 U.S. 837, 850 (1975).

Although IP transactions will be reflected by book entries rather than by the transfer of paper certificates, the absence of such certificates does not remove them from the term "certificate."[54] The system for IP transfer is similar to the immobilized depository system used in connection with modern day securities transfers, which likewise do not require a formal certificate.[55]

In addition to the fact that IPs fit within several of the more specific terms enumerated in Section 3(a)(10), it also is clear that the "economic substance" of an IP[56] is essentially

[54] L. Loss & J. Seligman, II *Securities Regulation* 597, 997-98 n.286 (3d ed. 1989).

[55] The absence of a certificated instrument does not alter the characterization of an instrument as a security. In this regard, it is noteworthy that, under relevant state commercial laws, the definition of the term "investment security" does not turn on whether investors can obtain certificated instruments to evidence their ownership interests. *See, e.g.*, Del. Code Ann. tit. 6 § 8-102(1)(c) (1988) [Uniform Commercial Code § 8-102(1)(c)]. Under state commercial laws in effect in at least 35 jurisdictions, the term "investment securities," specifically includes "uncertificated securities," transfers of which are registered upon books maintained for that purpose by or on behalf of the issuer. *See, e.g.*, Del. Code Ann. tit. 6 § 8-102(1)(b) (1988); Ill. Ann. Stat. tit. 26 § 8-102(1)(b) (1988); Consolidated Laws of N.Y. Ann. Book 62 1/2 § 8-102(1)(b) (1989). OCC will issue all CIPs, EIPs, and VIPs, and will maintain books for registering transfers of the same.

In addition, other investments routinely are issued or held in book-entry form. Several types of securities commonly trade without any physical, negotiable certificates evidencing ownership interests. For example, U.S. Treasury Bills, Bonds, and Notes are issued exclusively in book-entry form through Federal Reserve Banks. Moreover, numerous states have issued debt securities that restrict significantly an investor's ability to obtain negotiable certificates. *See* Securities and Exchange Commission, 53rd Annual Report 35 (1987); 51st Annual Report 25, 120 (1985); Securities Exchange Act Release No. 22168 (June 25, 1985), 50 FR 27078.

[56] The Court has on several occasions held that "in searching for the meaning and the scope of the word 'security' in the Act[s],

(Footnote continued on following page)

indistinguishable from the economic substance of the more specific instruments that are defined as securities by the statute. An investor who owns an IP will own an instrument having the same economic substance as a portfolio of stocks. The financial returns on the IP will be substantially identical to the returns from holding the underlying portfolio: capital gains or losses will be directly related to the gains or losses from the portfolio's stocks; cash payments made quarterly to the IP holder will consist of an amount equivalent to the regular cash dividends paid by the issuers whose securities comprise the portfolio; and margining treatment for the IP purchasers and sellers is identical to stock margin requirements. Thus, because the "economic substance" of the purchase of an IP is equivalent to the purchase of a portfolio of stock, and the attributes of IPs are those commonly associated with securities, an IP constitutes "an instrument commonly known as a security."

To the extent certain IP characteristics differ somewhat from the characteristics of stock, they resemble characteristics commonly found in rights to purchase or puts or calls on a security or index of securities—interests specifically denominated as securities by the Act.[57] In this regard, the cash-out and physical delivery features of IPs are the equivalent of a put or call right that accompanies the portfolio of stock represented by the IP, much like "buy-sell"

[56] *continued*

form should be disregarded for substance and the emphasis should be on economic reality." *See, e.g.* , *Tcherepnin*, 389 U.S. at 336 (1967).

[57] The futures commentators suggest that IPs are dissimilar to index options because there is no apparent premium paid by an IP long. In this regard, while IPs contain some characteristics of stock index options (*e.g.*, the issuance and clearance and settlement features of IPs are analogous to those of stock index options), the Commission believes that IPs predominantly have the attributes of a portfolio of common stock.

agreements for stocks.[58] In particular, the periodic cash-out feature merely creates a right similar to that commonly found in stock transactions where, at specified times, one party to a transaction has a right to purchase or sell a security according to a formula price that might be determined on the basis of book value, an appraisal, or a formula related to market value (whereas the IP right is related to the price of a specified index of securities).[59]

These additional attributes, like the other features of IPs, cause the IP to fall within the instruments included within the definition of the term "security" in Section 3(a)(10) of the Act.[60] Accordingly, for all of the above reasons, an IP is a security as defined in the Act.

2. IPs are not Futures

Futures commentators argue that the Commission lacks jurisdiction to authorize the trading of IPs on securities exchanges because IPs constitute stock index futures subject to the exclusive jurisdiction of the CFTC.[61] The Commission disagrees with the futures commentators' suggestion that IPs constitute futures contracts.

The term "futures contract" is not defined in the CEA or the CFTC's regulations. While characterization of the term

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[58] *See, e.g.*, D. Gladstone, *Venture Capital Handbook* 129-30, 237 (1983); Arley Merchandise Corp. [1984-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,878.

[59] Moreover, the addition of a periodic "buy-sell" or "put-call" right does not transform a security subject to such a right into a future; nor does it transform a portfolio of stock subject to such a right into a future; and it does not transform an IP into a future.

[60] *See* 15 U.S.C. §§ 77b(1) and 78c(a)(10) (1982).

[61] *See* Section 2(a)(1)(B) of the CEA.

"future" requires an examination of all the surrounding circumstances, futures contracts generally are: (1) standardized contracts imposing a bilateral obligation for the purchase or sale of commodities at a specific price that provide for future, as opposed to immediate, delivery on a specific date; (2) directly or indirectly offered to the general public; (3) secured by earnest money or "margin;" (4) entered into primarily for the purpose of assuming or shifting risk as opposed to transferring ownership of commodities; and (5) generally extinguished by executing off-setting contracts prior to the date on which delivery is called for by acceptance of a cash payment representing the difference in price between the initial and off-setting transactions.[62]

Not all of these characteristics are equally significant in determining whether an instrument is a future. In particular, the phrase that most commonly appears in the CEA is "contracts of sale of a commodity for *future* delivery."[63] The CEA's emphasis on the futurity of the contracts subject to its regulation, the common meaning inherent in the term "futures" contract, and the fact that case law that has sought to define the term "futures contract" has relied ex-

[62] Gilberg, Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws, 30 *Vand. L. Rev.* 1599, 1606-08 (1986). *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982); CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573 (9th Cir. 1982); CFTC v. National Coal Exch., Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,424 (W.D. Tenn. 1982); *In re* First Nat'l. Monetary Corp. [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,707 (CFTC 1983); *In re* Stovall [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,941 (CFTC 1979); Advance Notice of Proposed Rulemaking (Regulation of Hybrid and Related Instruments), 52 FR 47022 (December 11, 1987) at 47023.

[63] (emphasis supplied). I P.M. Johnson and T. L. Hazen, *Commodities Regulation*, §1.03 at 9 (3d ed. 1989).

tensively on the presence of future pricing (or delivery),[64] all suggest strongly that if a contract lacks the element of futurity it lacks the central distinguishing characteristic of a futures contract.

Since futurity is essential to a futures contract, and no element of futurity exists in an IP contract, an IP is not a futures contract. A stock index futures contract contains an element of futurity because the contract is the obligation to pay for or receive the value of the index at a predetermined date in the future. In stark contrast, however, an IP contract represents the *present* obligation to pay or right to receive the *current* value of an underlying portfolio of securities. In this respect, an IP is substantially the same as a transfer of a portfolio of securities that also gives rise to the *present* obligation to pay or right to receive the *current* value of the underlying portfolio of securities. Whereas the price of the IP is determined at the date of purchase, a futures contract is contractually defined by reference to a price that must be paid or received on a specific date in the future.[65]

In addition to lacking the element of futurity, IPs do not share with futures the element of *bilateral* obligation to receive or to pay the value of the index at a specified date in the future. Once the purchaser of the IP has made full payment for the contract the purchaser has no continuing obligations,[66] only rights. The purchaser has the right to sell out

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[64] *See* note 62, *supra*.

[65] The periodic cash-out feature of an IP does not cause the value of the IP ever to be defined on the basis of any price other than a *current* price, whereas the value of a future is always defined with reference to the expectation of the future price at the delivery date.

[66] If the IP purchaser has bought on margin, the purchaser may have a continuing margin obligation, but that obligation is to the lender, not to the IP seller. *See* note 40, *supra*.

the contract at any time, the right to hypothecate the contract, and the right to "cash out" the contract at pre-set periodic dates.[67] The obligation of an IP contract to make regular cash dividend equivalent payments falls unilaterally on the seller. The other obligation of an IP contract—to pay the present market price of the IP when the other side cashes out—is also unilateral.[68] More importantly, the IP cash-out obligation is fundamentally different from the obligation inherent in a futures contract because the IP obligation is contingent upon exercise of the cash-out privilege. Indeed, unless the privilege is exercised, the obligation is perpetual until the holder of the obligation extinguishes its IP position. No futures contract has this characteristic.

As noted previously, in addition to the primary elements of futurity and bilateral obligation, several other characteristics have been used to determine the existence of futures contracts.[69] In particular, the characteristics of standardization and offset provide little meaningful assistance in determining whether an instrument is a futures contract rather than a security. Other markets, such as stock options markets, regularly offer standardized contracts to the general public without having those contracts considered "futures

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67 The Commission believes that the cash settlement feature of an IP does not support the futures commentators' argument that in substance an IP is a stock index future. In the 1982 amendments to the definition of the term "security" contained in both the Securities Act and the Act, Congress explicitly recognized that products designed to have the economic substance of securities are themselves securities, even though settled in cash on the basis of the value of an underlying index.

68 The unilateral obligation falls only on the seller of a CIP or EIP, and on both parties with a VIP. The VIP obligations for the seller and purchaser are not bilateral in that each is discretionary because it is dependent on the exercise of the right imposing that obligation.

69 *Supra* note 62 and accompanying text.

contracts."[70] The fact that IPs are standardized and offered to the public neither adds to nor detracts from the Commission's conclusion that IPs are not futures. Similarly, the offset characteristics of IPs and stock options are identical. Specifically, as in the case of options, the sale of an IP with the same terms as the one purchased, or the purchase of an IP with the same terms as the one sold, will extinguish the previously established IP position. The availability of a secondary market to offset an IP position thus fails to distinguish IPs from other securities that are not futures and provides no support for the categorization of IPs as futures.

The requirement that futures contracts generally be secured by earnest money margin further differentiates IPs from futures contracts. Margining practices for IPs and futures are dramatically different. As noted above, as with stock, an IP purchaser pays the full purchase price for the IP investment at the time of purchase. Margin treatment for IPs will be analogous to stock margin requirements. The investor is required to pay the full purchase price of the IP at the time of purchase, but may borrow up to 50% to pay for the purchase. Thus, IP margins regulate credit. This is entirely unlike a futures transaction in which margin acts as a "good faith" deposit to ensure that the parties will meet their contractual obligations in the future.[71] Accordingly, the

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70 As another example, insurance contracts also are standardized, offered to the public, and can rely on the occurrence of future events, but are not considered "futures contracts."

71 *See generally* Figlewski, Margins and Market Integrity: Margin Setting for Stock Index Futures and Options, 4 *J. Futures Markets* 385 (1984). As recently explained in a Congressional report:

> Futures margins do not regulate credit, since no credit is granted on futures contracts. Futures margins constitute a (partial) guarantee that both parties will honor their financial

(Footnote continued on following page)

"margin" element of the definition of futures suggests that IPs are securities, not futures contracts.

The CME argues that, while an IP long position is entitled to be held indefinitely, the quarterly cash-out feature creates a quarterly expiration identical to the cycle now applicable for similar futures contracts. The CME asserts that this feature is synonymous with an "undated futures market contract."[72] The CME asserts further that the outcome of effective competition will be that at the time of purchase an IP long actually will pay a higher IP price reflecting payment of a commission to "roll over" the position, at the quarterly expiration date. The analogy to undated futures markets fails, however, for independent economic and legal reasons, and the contention that IP pricing will reflect payment of a "commission" to "roll over" this position is both speculative and irrelevant.

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[71] *continued*

obligations and thus function as a kind of performance bond. Moreover, futures margins, unlike securities margins, must be posted daily (sometimes intra-daily) to cover all daily losses on futures contracts. Report on the Regulation of Futures Margins, Comm. Print 100-6 (Aug. 1988) at 1, 8.

The futures commentators have argued that securities-style margining is fundamentally different from futures-style margining, and, for the reasons set forth by those commentators, the Commission agrees that IPs margins do not have the "earnest money" characteristic of futures contracts. *See, e.g.*, Testimony of William F. Brodsky, President, CME Before the House Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs (May 25, 1988) at 2-4; Statement of Karsten Mahlmann, Chairman, CBT Before the House Domestic Monetary Policy Subcommittee of the Committee on Banking, Finance and Urban Affairs (May 25, 1988) at 34; Notice of Petition for Rulemaking (Domestic Exchange-Traded Commodity Options; Margins), 54 FR 11233 (March 17, 1989).

[72] See , *e.g.*, 1st CME Letter at 2 [citing Gehr, Undated Futures Markets, 8 *J. Futures Markets*, 89 (1988)].

First, undated "futures" markets[73] require the joint determination of two prices: a spot commodities price and an associated intra-day interest charge[74] that is normally equal to the interest that could be earned by investing an amount equal to the value of the commodity plus the cost of one day's storage, *i.e.*, one day's carrying cost.[75] An investor cannot participate in the undated futures market without also paying or receiving the associated interest charge. Because of the need to incur this associated interest charge, the "futures contract" never gives rise to a present interest in the current value of a commodity. In contrast, IP contracts have no associated interest charge and constitute a *present* interest in a *current* value of an underlying portfolio. Thus, the presence of the associated interest charge creates in an "undated" futures market an element of futurity wholly absent from IPs.

Second, in regard to the suggestion that an IP long will pay a commission, in the form of higher prices, to "roll over" the position, the Commission believes that IP prices will be based largely on the value of the underlying portfolio and anticipated dividends on the components of the underlying index. The Commission does not believe that a "roll over"

73 Gehr describes the market studied in his article as a "curiosum." Gehr, *supra* note 72, at 89. No such curiosa exist in U.S. financial markets. Moreover, the fact that these markets might be called "futures" in Hong Kong or elsewhere does not mean that they would be defined as futures under the CEA. Finally, even if such markets were defined as futures markets under the CEA, the presence of a daily interest charge still would distinguish them from IPs.

74 The daily "interest" payments, made for the privilege of deferring, making or taking delivery of the commodity, may be "positive," paid by sellers to buyers, or "negative," paid by buyers to sellers. Gehr, *id.*, at 90-91.

75 *See* Gehr, *id.*, at 91.

expense necessarily will be incorporated into an IP premium. Moreover, even if such a de facto charge were to develop, the Commission does not believe that such a charge would transmute the IP into a "contract for future delivery" of the underlying index because of the IPs' other distinguishing characteristics.

The CME also suggests that the IP dividend payment is analogous to a cash payment from the short to the long, related to measured or theoretical shrinkages in the value of the underlying product, as occurs in the frozen skinned ham futures market.[76] The Commission observes, however, that dividends are discretionary corporate payments, the size of which is determined on a voluntary basis by the corporation's board of directors. Corporations can raise or lower dividends, and the right to receive dividends is a significant attribute of stock. Thus, the payment of a cash dividend equivalent to IP holders ensures that the IP contains the investment features of stock. In contrast, the shrinkage factor in a frozen skinned ham futures contract is determined according to a pre-set formula calculated in order to assure that purchasers of frozen skinned hams do not pay for a weight that will not exist at that point in the future when the contract expires and the ham has shrunk. The shrinkage factor is thus inexorably linked to the futurity of the ham contract (*i.e.*, but for futurity, no price adjustment for shrinkage would be necessary). The IP contract has no futurity, is not subject to shrinkage, and receives and pays dividends based on discretionary corporate decisions. The Commission thus rejects the argument that IPs should be considered futures because the shrinkage of frozen skinned hams is similar to the payment of corporate dividends.

[76] *See* 1st CME Letter at 2-3.

Finally, the CME suggests that the Phlx daily CIP cash-out does not alter its characterization as a futures contract. In this regard, the CME claims that:

> the differences between the S&P Futures and CIP are insignificant, relating solely to a probable slight difference in pricing related to the theoretical daily convergence of the cash and futures contract in the case of the PHLX CIP and the quarterly convergence in the case of the CME's S&P 500 futures. That difference is defined by well established arbitrage relationships reflecting the differences in maturity dates.[77]

It is not at all clear that the pricing differences between the S&P 500 future and the CIP will be "insignificant." Pricing of IPs and index futures should diverge because of the substantial differences in margining practices, divergences between an IP's perpetual nature and the quarterly expiration feature of a stock index future, and the payment of regular cash dividend equivalents on IPs. In addition, IPs will trade on markets with different marketmaking characteristics and may be bought or sold by retail investors who may not participate in the futures markets.[78] Many IP investors also may be effectively prohibited from participating in futures markets as a result of regulatory constraints or contractual prohibitions. Therefore, because of differences in the structure of the instruments, trading practices, and investor populations, it is unsubstantiated speculation to contend that the difference in pricing between IPs and index futures will be "insignificant."

In addition, the pricing differences between the S&P 500 future and all IPs (including those with quarterly cash-outs) will not replicate the formula commonly used to determine

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[77] *See* 5th CME Letter at 1.

[78] *See* note 96, *infra* and accompanying text.

the theoretical value of a stock index futures contract. Such a formula would add the interest on the price of the portfolio to the index price, subtract the annualized dividend yield, and factor in the days remaining until expiration.[79]

The futures commentators suggest that by manipulating the terms of this and similar equations they are able to demonstrate algebraic relationships between the pricing of IPs and the pricing of futures contracts, and thus that IPs should be regulated as futures because they are priced "like" futures. These equations, however, also can be used to demonstrate, by a different manipulation of the equation's terms, that existing futures contracts are equivalent to a straightforward stock portfolio position. It simply does not follow that futures should be regulated as stocks because they are priced "like" stocks, or vice versa. Similarly, IPs should not be regulated as futures merely because an algebraic manipulation of a pricing formula might demonstrate that they are priced like futures. Thus, the CME emphasis on pricing similarities is not determinative.

Other somewhat more complex arbitrage and equivalence relationships also do not serve to demonstrate that IPs are futures. For example, it is possible to create a synthetic future on a stock index by purchasing European style calls and

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[79] *See generally* B. Byrne Jr., *The Stock Index Futures Market* 170 (1987). The pricing formula contains the following elements:

> Futures price = (Stock Portfolio Price) + [(Risk Free Interest Rate – Annualized Dividend Yield on Stock Index) × Days Until Expiration / 365].

Unlike futures, the interest on the difference between full payment for a portfolio of stocks and the earnest money margin payment for a future would not be relevant to IP pricing because IPs are fully paid for at the time of the purchase. In addition, the value of expected dividends on the portfolio would not be subtracted because the IP purchaser would have the right to receive the equivalent of those regular cash dividends.

writing European style puts that have appropriate exercise prices and times to maturity.[80] "Hence when options on an asset or commodity are traded, but there is no futures market, it is always possible to construct a synthetic futures contract."[81] It does not follow, however, that, because futures positions can be replicated by options positions, futures are really options. Likewise, it does not follow that, because options positions can be replicated by futures, options are really futures. Similarly, futures can be used to replicate a variety of other securities. For example, futures can be used to create a portfolio that has the cash flow characteristics of a broad based equity portfolio. Again, it does not follow that an equity portfolio should be regulated as a future or that an index future should be regulated as a security because it is possible to define an arbitrage or equivalence relationship between them. Thus, while the modern theory of finance and its virtually limitless repertoire of equivalence relations may be very valuable for arbitrage, pricing and other analytic purposes, it is of little value when it comes to addressing the technical, legal issues of jurisdiction posed by the introduction of IPs and other financial products. Indeed, the limitless use of such models would be plainly inconsistent with the structure of the CEA and the securities laws, which are designed to separate regulation futures and securities.[82]

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[80] T. Copeland & J. Weston, *Financial Theory and Corporate Policy* 322 (3d ed., 1988).

[81] *Id.* at 323.

[82] When Congress in the CEA expanded the definition of the term "commodity" to include "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in," it carefully preserved this Commission's jurisdiction, including its authority to regulate novel instruments as securities. Specifically, Congress included a proviso that, with the exception of the grant of exclusive jurisdiction regarding contracts for future de-

(Footnote continued on following page)

Moreover, the determination that IPs are securities and not futures contracts is in no way inconsistent with the purposes of the CEA and subsequent amendments thereto. Futures regulation at the federal level is a direct outgrowth of serious problems in the marketplace that Congress perceived as detrimental to interstate commerce and the national public interest.[83] In 1936, when the CEA was en-

[82] *continued*

livery, "nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission . . . or (ii) restrict the Securities and Exchange Commission . . . from carrying out [its] duties and responsibilities . . . ." This is further emphasized in Section 2(a)(1)(A) of the CEA which provides that "nothing in this Act shall be deemed to govern or in any way be applicable to transactions in . . . security rights . . . *unless such transactions involve the sale thereof for future delivery conducted on a board of trade.* 7 U.S.C. § 2(a)(1)(A) (1982) (emphasis supplied).

The intent of Congress not to limit this Commission's traditional jurisdiction over the wide variety of financial instruments which fall within the broad definition of the term "security" under the federal securities laws was expressed repeatedly in the Act's legislative history. For example:

> Although the expanded definition of 'commodity' . . . includes rights and interests which are securities as defined in the federal securities laws . . . except as to transactions [involving delivery on a contract market], the expanded definition of commodity is *not intended to derrogate [sic] from the jurisdiction of the Securities and Exchange Commission . . . .*

See Report of the House Comm. on Agriculture to Accompany H.R. 13113, H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 28 (1974) (emphasis supplied).

Attempts to rely on arbitrage relationships to limit the scope of the Commission's jurisdiction over contracts that are not for future delivery are thus directly at odds with the language and intent of the CEA.

[83] 7 U.S.C. § 5 (1982).

acted (extensively amending the Grain Futures Act of 1922), Congress recognized that pervasive manipulation, excessive speculation, trading abuses (*e.g.*, wash sales, fictitious trades, and accommodation trades), and the rampant growth of boiler-rooms threatened to destroy the utility of the futures markets. In 1974, Congress determined that additional tools were necessary to ensure adequate regulation of all futures trading and futures professionals and to allow for the extension of the economic benefits of futures trading to those areas of commerce where the functions of futures markets might be useful.

Approval of IPs for trading on securities exchanges, in a fully regulated environment, would not give rise to the abuses that Congress sought to prevent by adopting the CEA. As exchange-listed securities, IPs will be subject to a comprehensive regulatory structure under the federal securities laws and to Commission oversight similar to the regulatory regime applicable to futures under the CEA.[84] Indeed,

[84] Bromberg, *Commodities Law and Securities—Overlaps and Preemptions*, 1 J. Corp. L. 217, 269 (1976). For example, both the Commission and the CFTC have the power to: (1) determine which contract markets and securities exchanges may operate under their respective jurisdictions; (2) establish the rules of membership and operation for the markets and exchanges under their respective jurisdiction; (3) oversee the exercise of self-regulatory authority by such markets and exchanges; (4) approve specific instruments for trading on those markets and exchanges; and (5) establish rules governing the registration and activities of brokers on those markets and exchanges. Indeed, it is important to note that both the securities and futures acts place a substantial emphasis on competition. *Compare* 15 U.S.C. §§ 78f, 78o, and 78o-3 (1982) *with* 7 U.S.C. § 19 (1982). In this regard, there is no basis upon which to conclude that Congress sought to adopt an expansive definition of the term "futures contracts" for the purpose of preventing competition by organized securities markets with the commodity markets.

the CFTC's regulatory authority over contract markets was modeled in part on the Commission's authority over securities exchanges.[85]

3. IPs Are Not Subject to the Investment Company Act

The Commission believes that an IP does not involve the creation of an investment company, because there is no "issuer," within the meaning of Section 3(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-3, that is either "engaged . . . primarily in the business of investing, reinvesting, or trading in securities" or "engaged . . . in the business of investing, reinvesting, owning, holding, or trading in securities, and owns . . . investment securities having a value exceeding 40 per centum of the value of such issuer's total assets . . . ." Moreover, OCC, the issuer of IPs, is a clearing agency registered as such under the Act. A clearing agency cannot be registered as such under the Act until the Commission makes certain findings required by Section 17A(b)(3), including that the clearing agency has the capacity to facilitate the prompt and accurate clearance and settlement of securities transactions and to safeguard securities and funds in its custody. These qualifications support the conclusion that the OCC would be an issuer primarily engaged "in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."[86] Moreover, given the existing securities law regulation of the OCC under Section 17A of the Act and the exchanges under Section 6 of the Act, the Commission sees

[85] Courts also have observed that the "[s]tructure and power of the CFTC are duplicative of the SEC." Mullis v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 492 F. Supp. 1345, 1350 (D. Nev. 1980).

[86] *See* Section 3(b)(1) of the Investment Company Act of 1940. 15 U.S.C. § 80a-3(b)(1) (1982).

no purpose that would be served by subjecting this arrangement to investment company regulation.

Nor does there exist an investment company within the OCC (or OCC combined with the exchanges), the IP purchasers viewed collectively, or the IP shorts viewed collectively. Unlike *Prudential Ins. Co. v. SEC*,[87] where the Third Circuit affirmed a finding of the Commission that the "Investment Fund" resulting from the sale of annuity contracts to a group of purchasers[88] constituted a separate investment company, the Commission has found no separate investment company herein. In the case of IPs, nothing exists comparable to the Investment Fund in *Prudential*, which the court found to be a "completely segregated account, devoted to investing in securities."[89]

B. Benefits of Market Baskets

The Division of Market Regulation's Report on *The October 1987 Market Break* ("Staff Report"),[90] *An Overview of Program Trading and Its Impact on Current Market Practices* ("Katzenbach Report"),[91] Commission recom-

[87] 326 F.2d 383 (3d Cir. 1964), *cert. denied*, 377 U.S. 953 (1964).

[88] As discussed earlier, the term "investment company" requires a finding that there exists an "issuer;" the term "issuer" is, in turn, defined to include "every person;" the term "person" is defined to include a "company;" and "company" is defined to include "any organized group of persons, whether incorporated or not." 15 U.S.C. §§ 80a-3(a)(1), 2(a)(22), 2(a)(28), 2(a)(8) (1982).

[89] *Prudential*, 326 F.2d at 387 (1964).

[90] Division of Market Regulation, *The October 1987 Market Break* (February 1988) ("Staff Report").

[91] N. Katzenbach, *An Overview of Program Trading and Its Impact on Current Market Practices* (December 21, 1987) ("Katzenbach Report").

mendations,[92] and testimony by the Commission[93] suggested, among other things, that the listing and trading of a basket of stocks on an exchange could help ameliorate the volatility and steep stock price declines experienced during and since October 1987. As noted in the Staff Report, the creation of one or more posts where actual baskets or portfolios of stock could be traded could alter the dynamics of program trading, because the availability of such basket trading could, in effect, restore program trades to more traditional block trading techniques.[94] The Staff Report noted further that, while arbitrage ultimately would flow to individual component stocks, many institutional investors and member firms effecting index arbitrage transactions could focus their equity transactions at the basket posts where the specialist and trading crowd could provide efficiencies associated with effecting transactions in a portfolio of securities as opposed to individual stocks. This could add an additional layer of liquidity to the market to help absorb the velocity and concentration of trading associated with index-related trading strategies.[95] Moreover, because market baskets would be traded at a single location on the exchange floor,

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92 Securities and Exchange Commission Recommendations Regarding the October 1987 Market Break (February 3, 1988).

93 Testimony of David S. Ruder, Chairman, SEC, Before the Senate Committee on Banking, Housing, and Urban Affairs, on February 3, 1988.

94 Staff Report at 3-18.

95 *Id.* Similar ideas have been discussed in J. Grundfest, "Would More Regulation Prevent Another Black Monday?," Address before the CATO Institute Policy Forum on July 20, 1988, at 13-14 (available at the Commission); H. Stoll and R. Whaley, Program Trading and the Monday Massacre (November 4, 1987) (available at the Owen Graduate School of Management, Vanderbilt University); and H. Stoll, *Portfolio Trading*, Working Paper No. 87-14 (Sept. 1987) (available at the Owen Graduate School of Management, Vanderbilt University).

at which program trading order flow could be concentrated and imbalances in such trading determined, they would not result in the same market information limitations that result from executing program trades in the individual stocks. Finally, as separate consolidated products, market baskets would be easy and inexpensive to clear and settle and could provide an alternative vehicle for retail customers to invest in "the market."

For the reasons discussed below, the Commission believes that IPs will provide retail investors with a cost efficient means to make investment decisions based on the direction of the market as a whole[96] and may provide stock market participants several advantages over existing methods of effecting program trades of stocks.[97]

Because IPs would be traded as market baskets at a single specialist post on the exchanges' floors, program trading

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96 Because of the small retail size of index participations and the attendant costs of executing sufficient IP transactions in an attempt to replicate large portfolios, the Commission believes that such instruments are designed to handle retail investor interest to invest in the "market". The Phlx, Amex, and CBOE believe that IPs could be used by retail investors to make investment decisions based on the direction of the market as a whole, thereby providing them with a cost efficient means by which to take advantage of anticipated market swings. In addition, an IP investment could provide an individual investor with an additional source of securities income. The product could also be useful to institutional investors for their investment strategies.

97 In this regard, the Commission believes that the listing and trading of IPs on national securities exchanges may reduce market volatility associated with program trades of stock because, excluding the Amex EIP, IPs generally will be cash-settled, and existing exchanges' stock index options surveillance procedures will be applicable to IPs. The Amex notes that the share delivery alternative provides a feature discussed in the Staff Report and will enhance the utility of EIPs for institutions. Staff Report at 3-19 to 3-20.

order flow involving IPs can be concentrated at that post and imbalances in such trading determined. Thus, IPs trading would not result in the same market information limitations that result from executing program trades in individual stocks. Moreover, the availability of IPs may provide a more efficient alternative to direct program trades of individual stocks for some institutional investors. Finally, as a separate product, IPs would be easy and inexpensive to trade, clear and settle.

C. EIP Physical Delivery Proposal

The Commission also believes that the Amex proposal to permit physical delivery of its EIPs is consistent with the Act. Indeed, the availability of physical delivery permits institutions to employ EIPs to adjust their stock portfolios. As a result, EIPs may have a greater potential for providing the liquidity benefits envisioned for market baskets in the Staff Report. Although providing certain benefits, the Amex's proposed EIP physical delivery does raise some concerns. The Amex's proposed rule change provides for a physical delivery facilitator ("PDF") to make physical delivery of the component stocks of the underlying portfolio to EIP holders who exercise the delivery privilege, if and only if, the number of delivery units for which holders have requested physical delivery exceeds the number of delivery units offered for physical delivery by persons holding short positions. The Amex proposes to inform the PDF, several hours before the opening of trading, of the imbalance between delivery units offered and delivery units demanded in order that the PDF may make arrangements that would enable it to obtain as agent at the opening the additional shares of the stocks that constitute the underlying portfolio to satisfy its obligations.

The Commission believes that PDF pre-opening knowledge of the imbalance between delivery units offered and

delivery units demanded can provide the PDF with an informational advantage concerning pre-opening order flow. Because this imbalance would always be on the buy side, and because its existence and magnitude would be known only to the PDF, the AMEX proposal raises the possibility that the PDF might take advantage of the information by establishing or liquidating stock, options, and/or futures positions. In this regard, however, the Amex will place restrictions on the PDF's function. In particular, the PDF must announce to the trading crowd, and the Exchange shall cause to be publicly reported, the physical delivery unit imbalance at or prior to 9:00 A.M. on Exercise Friday. Thus, the PDF's opportunity to trade on "inside" market information should be substantially reduced. Moreover, because the PDF must satisfy the physical delivery unit imbalance only by purchasing such imbalance at the opening rather than utilizing its existing inventory, the PDF's role is limited to that of an agent. Accordingly, the Commission believes the Amex has sufficiently addressed any concerns about the physical delivery mechanism.

D. Phlx Blue Chip Index

Certain of the proposed underlying portfolios, such as the Amex MMI and the S&P 500, have been published for several years and have been used as a basis for stock index options trading. In approving these portfolios as bases for options trading (and commenting on them for future trading), the Commission has determined that the use of these underlying portfolios does not raise manipulation concerns.[98] The Commission believes that the introduction of IPs based on these portfolios should not raise additional manipulation

[98] *See* Section 6(b)(5) of the Act, 15 U.S.C. § 78f(b)(5) (1982), which requires that the rules of a national securities exchange be designed to prevent fraudulent and manipulative practices.

concerns.[99] The Phlx, however, has developed, specifically for IPs trading, a new Blue Chip CIP.

For several reasons, the Commission does not believe that the Blue Chip CIP raises significant manipulation concerns. Although the Blue Chip CIP is comprised of only 25 securities, it represents approximately 13 industry groups and is designed specifically to replicate the performance of the DJIA. The broad diversification, large capitalization, and deep and liquid markets of the portfolio's component stocks significantly minimize the potential for manipulation.[100] The ten most highly price-weighted stocks in the Blue Chip CIP account for less than 58% of the portfolio's cumulative market value.[101] Although IBM accounts for 8.73% of the Blue Chip CIP's price-weighting, the Commission believes manipulation of the CIP through trading in IBM is made more difficult because the stock is widely held and actively trad-

[99] The Commission believes that IPs will not raise the same problems as other portfolio-related products regarding to intermarket trading strategies that at times may have increased the concentration and velocity of market movements. While the Commission notes that IPs will create arbitrage opportunities with either the cash market or other derivative products, and may spawn new intermarket trading strategies, because of the proposed 50% margin requirement for IPs (analogous to stock margin requirements) the leverage concerns that exist with other equity derivative products are absent. *See* Report of the Presidential Task Force on Market Mechanisms (January 1988), at III-7; Division of Market Regulation, *The October 1987 Market Break*, (February 2, 1988) at 11-1. Moreover, by providing market participants with a means to trade "the market" without buying and selling dozens or hundreds of individual stocks, IPs could lessen the impact of portfolio trading strategies.

[100] The Blue Chip CIP is price-weighted. Accordingly, an issue's weight in the total portfolio value is based on its price per share rather than its total market capitalization (*i.e.*, price per share times the number of shares outstanding).

[101] By comparison the 10 most highly price-weighted stocks in the MMI account for approximately 70% of that portfolio's cumulative market value.

ed.[102] In addition, the proposed trading of IPs by the exchanges, which already have well-established stock and options surveillance procedures, does not appear to give rise to major surveillance concerns because existing surveillance procedures will be applicable to IPs trading. In addition, the Phlx has the necessary surveillance sharing arrangement with the exchanges whose securities comprise the Blue Chip CIP. Specifically, the Phlx and the NYSE are members of the Intermarket Surveillance Group ("ISG").[103] As members, these markets are required to share surveillance information with one another.

E. Proprietary Concerns

In general, the Phlx argues that simultaneous Commission approval of the Amex's proposed rule change to trade IPs would neither be in the public interest nor promote fair competition among exchange markets. In support of this view the Phlx suggests that Commission approval of Amex's "copy cat" filing would deprive the Phlx (which claims to be the IP developer) of the opportunity to take advantage of the primary market phenomenon. In addition, the Phlx suggests that such Commission approval would stifle product innovation, design, and creativity. The Commission is of the view that approval of the Amex and Phlx proposals simultaneously is consistent with the Act.

To the extent that Phlx's "copy cat" argument implicates a claim of misappropriation or infringement of a protected

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[102] For the period February 1988 through January 1989, IBM's Average Daily Volume ("ADV") was approximately 1,357,900 shares.

[103] The on-going task of the ISG is to create and maintain a coordinated intermarket surveillance system to ensure that intermarket surveillance concerns are appropriately addressed.

property right, the Commission believes it is inappropriate for it to attempt to resolve these issues in a proceeding involving the approval of securities to be traded in a particular market place. Congress has enacted an elaborate statutory framework for the establishment, preservation, and protection of intellectual property rights and established specific federal agencies (*e.g.*, the U.S. Patent and Trademark Office and the U.S. Copyright Office), to administer these laws. Separate state causes of action also may be available to Phlx. Neither the plain language of these statutes nor any provision of the Act suggests that Congress intended that the Commission attempt, in the context of an approval proceeding, to resolve intellectual property right claims that can be pursued elsewhere.

Moreover, while the Commission recognizes that, under the appropriate circumstances, incentives for innovation can promote long term competition and provide substantial benefits to the marketplace, on the basis of the record in this proceeding the Commission believes that simultaneous approval of the Phlx, Amex, and CBOE proposals is consistent with the Act. The Commission has been presented with numerous proposals to list and trade new securities products in recent years. In particular, the Commission, on November 22, 1982, approved a number of exchange proposals to trade narrow and/or broad based index options, often on similar or identical indexes, although such indexes were submitted to the Commission on different dates.[104]

The Commission recognizes Phlx's argument that IPs are a novel product involving substantially more innovation than past new options products. Nevertheless, the Commission believes that the opportunity for competition among mar-

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[104] *See* Securities Exchange Act Release No. 19264 (November 22, 1982), 47 FR 53981.

kets trading IPs simultaneously furthers the purposes of the federal securities laws.[105] Past experience has indicated that an exchange which initially commences trading an options contract has an extremely large advantage over any subsequent competitor. Accordingly, the Commission is concerned that a temporary grant of exclusivity to the Phlx could have the effect of substantially reducing potential future competition in IPs, which effect outweighs the benefits of incentives to innovation that might, in this case, result from a temporary grant of exclusivity. Thus, the Commission has concluded that simultaneous approval of the proposals is consistent with the Act.

F. Regulation of Member Organizations Doing Business with Public Customers

1. Disclosure

In order to promote investor protection and to ensure adequate disclosure in connection with IPs, the Phlx, Amex, and CBOE propose that their rules pertaining to standardized options and the requirements of Commission Rule 9b-1 also apply to IPs trading.[106] In this regard, the OCC requests

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[105] *See* Securities Exchange Act Release Nos. 18297 (December 2, 1981), 46 FR 60376 ("Unrestricted inter-exchange competition in the non-equity options markets most likely would result in the development of options contracts best suited to the economic needs of market participants rather than discourage innovation, research, and development of new products"), 22026 (May 8, 1985) 50 FR 20310 ("The goals of the Act are inconsistent with affirmatively delaying the start-up of trading in options on over-the-counter stocks in a manner that benefits one particular market place because there is no regulatory purpose which would require such a delay").

[106] The applicability of Rule 9b-1 relieves an issuer from the requirement of delivering a prospectus to each IP customer. Nevertheless, an issuer must deliver its prospectus to each market upon which the IPs are traded, for the purpose of redelivery to IPs customers upon their request.

that the Commission issue an order pursuant to Rule 9b-1(a)(4) of the Act, treating IPs for disclosure purposes as another type of security that should be treated in a manner similar to "standardized options" Under Rule 9b-1.[107] OCC suggests that each of the reasons cited by the Report of the Special Study of the Options Market ("Options Study")[108] for establishing a separate disclosure system for standardized options applies equally to IPs.

As with other securities issued by OCC, the clearing corporation interposes itself between IP buyers and sellers, and is technically the "issuer" of each contract. Moreover, just as with other OCC issued securities, the Commission believes providing investors with detailed descriptive information regarding the issuer would not be useful. Instead, a disclosure document that provides a discussion of the terms and risks of IPs would appear to be substantially more useful to investors.

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[107] *See* Letter from William H. Navin, Schiff Hardin & Waite, OCC legal counsel, to Richard G. Ketchum, Director, Division of Market Regulation, and Linda C. Quinn, Director, Division of Corporation Finance, SEC, dated July 6, 1988 ("Schiff Letter"). The Schiff letter requests also that IPs be treated in a manner similar to standardized options for purposes of Rules 134a and 153b and Form S-20 under the Securities Act of 1933 ("Securities Act"). In addition, the Schiff letter requests that the Commission staff confirm that IPs will be treated in a manner similar to standardized options for the purpose of calculating Securities Act registration fees and that Form 8-A will be available for IP registration under the Act notwithstanding that OCC is exempt from the periodic reporting requirements of the Act. *See* Schiff letter at 5 and 6 for a more detailed explanation. Moreover, although the exchanges have not requested exemption of IP underlying securities from the applicability of Rule 12a-6 of the Act, the Commission notes that pursuant to that Rule IP underlying securities are exempt from the operation of Section 12(a) of the Act.

[108] *Report of the Special Study of the Options Markets to the Securities and Exchange Commission*, 96th Cong., 1st Sess. (Comm. Print 1978) ("Options Study").

The Commission believes that the reasons cited by the 1978 Options Study for establishing a separate disclosure system for other OCC issued securities are equally applicable to IPs. First, regular disclosure under the Securities Act of 1933 ("Securities Act") focuses on disclosures regarding the issuer of the security. As with other OCC issued securities providing this type of disclosure to investors is not useful for IPs. While OCC's solvency is obviously relevant, an investor primarily is purchasing the equivalent of a portfolio of stock. Accordingly, a disclosure document that provides a discussion of the terms and risks of IPs would appear substantially more useful to investors. Second, delivery of a Securities Act prospectus to all IP investors and redelivery of any updated prospectus would be an inefficient and unnecessarily costly way of educating the public regarding IPs. In this regard, OCC has prepared a special IPs disclosure document ("IDD") explaining in detail the economic and risk characteristics of IPs, the mechanism of buying, selling and exercising IPs, and the market in which IPs will trade.[109]

In addition, the Amex, Phlx, and CBOE propose to require that every exchange member and member organization deliver to each customer a current IDD at or prior to the time such customer's account is approved for IPs trading.[110]

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[109] In reviewing any disclosure materials submitted, the Commission intends to assure that the materials specifically describe IPs, explain their uses, detail the special risks associated with IPs trading, and emphasize that IP contracts, unlike options, obligate a writer to pay to the holder an amount equivalent to a proportionate share of dividends declared on the underlying index components.

[110] *See e.g.*, Amex Rule 926(a). The Commission believes that prior distribution of the IDD to investors is necessary before that person may effect a transaction in IPs. This prior distribution could be accomplished by physically delivering an IDD to an investor before he effects an IP transaction or by a mass mailing of the IDD

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As a result, the Commission believes that IPs are a type of security that falls into the category of "other security" under Rule 9b-1 which the Commission should treat in a manner similar to standardized options for purposes of Rule 9b-1 under the Act.[111] Indeed, in amending the definition of the term standardized option to include "such other securities as the Commission may, by order, designate" the Commission noted that it added the new language "to authorize the Commission, by order, to allow the use of Rule 9b-1 for new investment vehicles that the Commission believes should be included within the new disclosure framework."[112]

For the reasons discussed above, the Commission also believes that IPs should be treated in a manner similar to standardized options for purposes of Rules 134a and 153b and Form S-20 under the Securities Act. The Commission further believes that IPs should be treated similarly to standardized options for purposes of calculating Securities Act registration fees and that Form 8-A will be available for IP registration under the Act.

2. Marketing of IPs

The exchanges propose further that their existing options suitability rules[113] be applied to IP transactions. In general, under these procedures, before approving a customer's account for stock options trading, a firm must seek to obtain

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110 *continued*

to customers who have been approved for options trading, followed by a period of time in which investors could comprehend the IDD and other relevant information pertaining to the economic and risk characteristics of IPs trading.

111 17 C.F.R. § 240.9b-1(a)(4) (1988).

112 *See* Securities Exchange Act Release No. 19055 (September 16, 1982), 47 FR 41950, 41954.

113 *See, e.g.*, Phlx Rule 1026; CBOE Rule 9.7.

background and financial information including, among other things, the customer's investment experience, employment status, net worth, annual income, age, and investment objectives.

The Commission believes it appropriate that the exchanges apply the heightened suitability requirements of their options suitability rules to IPs transactions. Thus, no exchange member or member organization shall recommend to any customer any IP transaction unless such member or member organization has reasonable grounds to believe that the recommended transaction is not unsuitable for such customer.

The exchanges also propose that registered representatives who are qualified to sell stock index options should not be required to take a separate examination in order to transact business concerning index participations.[114] In addition, the exchanges do not propose that Registered Options Principals be required to take a separate IPs examination to qualify to act in a supervisory capacity with respect to the sale of IPs to public customers. The Commission concurs with the exchanges' proposals.[115]

In addition, the exchanges propose that IPs be subject to position and exercise limits of 15 million IPs with respect to any particular underlying portfolio, and that each member and member organization shall file with the exchanges a report with respect to each account in which such member or member organization has an interest, each account of a

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[114] *See, e.g.*, Phlx Rules 1024 and 1025; Amex Rules 920 and 922.

[115] Nevertheless, once IPs are approved for trading, we would anticipate that the question files for both the General Securities Representative and Registered Option Principal Examinations would be updated to include questions concerning index participations.

partner, officer, director or employee of the member organization, and each customer account, which has established an aggregate position of 200,000 IPs (whether long or short) covering the same underlying portfolio. These rules are designed, in part, to limit the ability of IP traders to manipulate or disrupt the market for IPs or the underlying securities and to provide the exchanges and the Commission with empirical data concerning the development of the IP market. In addition, such limits should help protect OCC from unacceptable risk. An IP position at the maximum level would have a current market value of approximately $390 million, less than for stock index options ($625 million). The Commission believes that fixed maximum position and exercise limits of 15 million IPs and the proposed 200,000 aggregate position reporting requirement of IPs are sufficient to achieve their intended purposes.

The exchanges propose to halt or suspend trading in IPs whenever the exchanges deem such action "appropriate in the interests of a fair and orderly market" and to protect investors.[116] This proposal is based on the assumption that accurate prices may be based only upon accurate pricing of the underlying portfolios. The Commission believes that this proposal is consistent with the Act.[117]

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[116] *See, e.g.*, Phlx Rule 1047A. A trading halt in the primary market for underlying stocks accounting for 20% or more (in the case of CBOE) or 50% or more (in the case of Amex) of the portfolio value now will be one of several factors that may be considered by the exchanges in determining whether to halt trading in the IP.

[117] The recent Commission approval of proposed rule changes submitted by the NYSE, Phlx, Amex, and CBOE to halt trading on the exchanges for one hour if the Dow Jones Industrial Average ("DJIA") declines 250 or more points from its previous day's close and an additional two hours if the DJIA declines 400 points from its previous day's close ("circuit breaker" proposals) would be applicable to IPs. In this regard, the Phlx circuit breaker pro-

(Footnote continued on following page)

3. Regulation T

The initial sale of an IP, by definition, will require the seller to go short. Accordingly, it is necessary to determine what margin treatment for IPs is appropriate. In this regard, the Phlx, CBOE, and Amex requested an interpretation from the FRB[118] that IPs be treated as equity securities rather than securities options under the relevant provisions of Regulation T.[119] The FRB's staff has issued a letter not objecting to the commencement of IPs trading employing the proposed initial (50% margin for IP purchases and 150% margin for IP shorts) and maintenance (130% of the value of all short IP positions and 25% of the value of all IP

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117 *continued*

posal does not alter existing Exchange trading halt and suspension rules. *See* Securities Exchange Act Release No. 26386 (December 22, 1988), 53 FR 52904. Thus, when the circuit breaker is activated Phlx Rule 1047A, which applies to CIP trading, will cause trading in CIPs to be halted because more than 20% of the value of the underlying security is not trading. In addition, the Amex circuit breaker proposal provides that all securities will halt trading on the exchange when the predetermined limits are reached. *See* Securities Exchange Act Release No. 26198 (October 19, 1988), 53 FR 41637. Because the Amex proposed EIP rule change defines the instrument as a security, EIPs will halt trading when the circuit breaker is activated. Moreover, although CBOE's circuit breaker proposal provides for the cessation of trading in stock options and stock index options when the predetermined limits are reached, the proposed CBOE VIP rules provide that VIP's will halt trading when 20% of the value of the underlying security is not trading. Thus, when the circuit breaker proposal halts trading on the Exchange VIPs also will cease trading.

118 *See, e.g.*, Letters to Laura Homer, Securities Credit Officer, FRB from Richard Chase, Executive Vice President, Phlx (February 3, 1988) and from Gordon L. Nash, Senior Executive Vice President, Legal and Regulatory Affairs, Amex (March 8, 1989).

119 *See* 12 C.F.R. §§ 220.5(c) and 220.18(a), (c), and (f) (1988).

long positions maintained in customer margin accounts) margin for IPs.[120]

4. Clearance and Settlement

The exchanges propose to have IPs cleared and settled by the OCC. In this regard, on March 3, 1988, the OCC filed with the Commission a proposed rule change to enable the OCC to issue, clear, and settle index participations.[121] The proposal will allow the OCC to process IP transactions in accordance with procedures that are substantially similar to OCC's well-established systems and procedures.[122]

V. Conclusion

Based upon the aforementioned factors the Commission finds that the proposed rule changes relating to the listing and trading of index participations are consistent with the requirements of Section 6(b)(5) and the rules and regulations thereunder.[123] The initiation of IPs trading, however, is conditioned upon:

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[120] *See* Letter from Laura Homer, Securities Credit Officer, FRB, to Richard Ketchum, Director, Division of Market Regulation, SEC, dated March 20, 1989. The exchanges proposed rule changes also contemplate the use of escrow receipts as cover for IP short positions and special margin treatment for certain market strategies. Currently, the exchanges and the FRB are in the process of working out such details. Thus, amendments to the margin regulations may be necessary.

[121] *See* Securities Exchange Act Release No. 25529 (March 29, 1988), 53 FR 10960.

[122] The Commission approved the OCC's proposed rule change to issue, clear, and settle IPs simultaneously with the exchanges' proposed rule changes to list and trade IPs. *See* Securities Exchange Act Release No. 26713 (April 11, 1989).

[123] The Commission notes that approval of the proposed rule changes is based upon a determination that the terms of the IPs

(Footnote continued on following page)

(1) issuance of an order under Rule 9b-1 approving the IPs disclosure document; and

(2) issuance of an order approving the OCC's proposed rule change to issue, clear, and settle IPs.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[124] that the proposed rule changes be, and hereby are, approved.

By the Commission.

JONATHAN G. KATZ
Secretary

Dated: April 11, 1989

Concurring Statement of Commissioner Cox

I concur in the Commission's finding that these products are securities. I also concur in the Commission's reasoning, except insofar as the order argues that the products are actually "stock" within the meaning of Section 3(a)(10). I believe an IP may reasonably be classified as a "certificate of interest or participation." Moreover, the fact that IPs share so many of the characteristics of stock and other securities products strongly suggests that Section 3(a)(10)'s residual classification for "any instrument commonly known as a 'security' " should be read to include IPs.

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[123] *continued*

contracts, at the present time, are consistent with the requirements of the Act. If the terms of the IPs contracts are changed in a material way, however, it would be necessary to publish notice of that change as an amendment to the filing in order to afford the public an opportunity to review the proposed modification and for the Commission to review its prior determination.

[124] 15 U.S.C. § 78s(b)(2) (1982).

APPENDIX C

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-26713; File No. SR-OCC-88-02)

Self-Regulatory Organizations; Options Clearing Corporation; Order Approving Proposed Rule Change Providing for the Issuance, Clearance, and Settlement of Index Participations

I. Introduction

On March 3, 1988, the Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change (File No. SR-OCC-88-02) under Section 19(b) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder.[2] The proposal would enable OCC to issue, clear, and settle a new product known as Index Participations ("IPs") whose value is determined by reference to the value of an underlying stock index. The Commission published notice of the proposal in the *Federal Register* on April 4, 1988.[3] OCC amended the proposed rule change on June 3, 1988,[4] Decem-

[1] 15 U.S.C. §78s(b)(1).

[2] 17 C.F.R. §240.19b-4.

[3] Securities Exchange Act Release No. 25529 (March 29, 1988), 53 FR 10960. As originally proposed, the rules referred to IPs as Cash Index Participations ("CIPs"). CIPs initially were proposed by, and would be listed and traded on, the Philadelphia Stock Exchange, Inc. ("Phlx"). *See* Securities Exchange Act Release No. 25495 (March 23, 1988), 53 FR 10311, providing notice of proposed rule change by Phlx that would enable Phlx to list and trade CIPs based on two stock market indexes.

[4] Securities Exchange Act Release No. 25867 (June 29, 1988), 53 FR 25560. Because the American Stock Exchange, Inc. ("Amex") proposed to list and trade Equity Index Participations ("EIPs") pursuant to rules then similar to those proposed by Phlx for CIPs

(Footnote continued on following page)

ber 19, 1988,[5] January 27, 1989, and March 16, 1989.[6] The Commission received four comment letters opposing the proposed rule change.[7] For the reasons discussed below, the Commission has determined to approve the proposed rule change.[8]

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4 *continued*
[*see* Securities Exchange Act Release No. 25664 (May 5, 1988), 53 FR 16805], the amendment, among other things, changed the name of the product in OCC's proposed rules from CIPs to IPs so that the rules may apply generally to IPs. Subsequently, the Chicago Board Options Exchange, Inc. ("CBOE") submitted proposed rule changes to list for trading Value of Index Participations ("VIPs") [*see* Securities Exchange Act Release No. 25799 (June 13, 1988), 53 FR 22754).

5 *See* Securities Exchange Act Release No. 26388 (December 22, 1988), 53 FR 52901. This amendment conforms OCC's proposed IP rules to the proposed rules, as amended, filed by the exchanges.

6 Because these amendments contain no new concepts but merely modify rules previously proposed by OCC, the amendments have not been published for comment in the *Federal Register*. The amendments make OCC's proposed rules more precise and respond to various comments on the proposed rules that OCC had received.

7 *See* letter from Thomas R. Donovan, President, Chicago Board of Trade, to Jonathan G. Katz, Secretary, SEC, dated April 26, 1988; letter from Philip L. Stern, Freeman, Freeman & Salzman, P.C., on behalf of the Chicago Mercantile Exchange ("CME"), to Jonathan G. Katz, Secretary, SEC, dated April 29, 1988; letter from Philip L. Stern, Freeman, Freeman & Salzman, P.C., on behalf of the CME, to Jonathan G. Katz, Secretary, SEC, dated August 2, 1988; and letter from Jerrold E. Salzman, Freeman, Freeman & Salzman, P.C., on behalf of the CME, to Jonathan G. Katz, Secretary, SEC, dated January 11, 1989. These commentators opposed the OCC filing for the same reasons set forth in comment letters opposing the parallel exchange rule filings. Accordingly, these comments are discussed in Securities Exchange Act Release No. 26709 (April 11, 1989), ("Exchange approval order"). *See* note 37, *infra*.

8 The Commission also has approved the related exchange rule filings (SR-Phlx-88-07, SR-Amex-88-10, and SR-CBOE-88-09) enabling the exchanges to list and trade a variety of IP products. *See* Exchange approval order, *id*.

II. Description of the Proposal

The proposal amends OCC By-Laws and Rules to provide for the issuance, clearance, and settlement of IPs. An IP is a product whose value is determined by reference to the value of an underlying stock index.[9] IPs were designed to place the holder of an IP in an economic position substantially equivalent to that of a purchaser of a portfolio or basket of stocks comprising the underlying index. A holder of an IP would be entitled to receive, and the writer of an IP would be obligated to pay, a quarterly dividend equivalent. The dividend equivalent would equal the regular cash dividends accrued over the quarter which the owner of a basket of stocks described above would be entitled to receive; it would not include stock dividends or extraordinary cash dividends. An IP would exist until the holder or writer extinguishes the IP by entering into an offsetting writing or purchasing transaction, or exercises a "cash-out privilege" that is available, depending on the IP, on a daily, quarterly or semi-annual basis.

The cash-out privilege provides for a payment in cash based upon the current value of the component stocks of the underlying index at the time specified by each exchange during which the privilege is available.[10] For example, Phlx's

[9] The Phlx has designated two indexes for CIP trading: the Blue Chip Index, a price-weighted index composed of 25 highly capitalized listed common stock issues representing primarily industrial corporations which is designed to reflect the performance of the Dow Jones Industrial Average ("DJIA"), and the Standard & Poors 500 ("S&P" 500) Index. The Amex EIPs will be based on the Major Market Index ("XMI") and the S&P 500 Index. CBOE VIPs will be based on the capitalization-weighted CBOE 50 and CBOE 250 indexes developed and maintained by the Exchange, and the S&P 500 Index. All IPs covering the same index group and having identical contract terms constitute a "class of IPs."

[10] Tne days on which the cash-out privilege is available for IPs traded on each Exchange are stated in Interpretations added

(Footnote continued on following page)

proposed IP rules provide that the cash-out privilege would be available to holders of IPs on any business day. Pursuant to the proposed Phlx rules, however, exercise of the cash-out privilege would entitle an exercising holder to an "aggregate cash-out value"[11] computed in a different manner depending on the day of exercise. If the CIP holder exercises on the business day before an IP dividend equivalent day, the aggregate cash-out value would be based on the opening values of the stocks in the underlying index on the IP dividend equivalent day. If the CIP holder exercises on any other business day, the aggregate cash-out value would be based on the closing index value on the business day following the exercise, reduced by one-half of one percent.

For CBOE VIPs, each writer as well as each holder would be entitled to a cash-out privilege on a semi-annual basis. These IPs therefore are referred to in OCC's proposed rules as "two-way IPs." The writer's cash-out privilege would entitle the writer to extinguish the short position and pay the cash-out value. Holders of two-way IPs would have a corresponding obligation, upon assignment of a writer's exercise notice, to extinguish long IP positions in exchange for payment of the cash-out value.

On the Amex, EIP holders would be entitled to exercise either the cash-out privilege or a delivery privilege on a

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[10] *continued*
OCC's Rules. Generally, the cash-out time for each quarterly or semi-annual period, depending on the IP, will be determined and made public by each Exchange before the beginning of such period. Amex has determined that its cash-out time will coincide with "dividend equivalent day"—the third Friday of March, June, September and December. *See* Rule 1903, Interpretations and Policies .02, .03 and .04.

[11] Aggregate cash-out value is equal to the settlement index value times the index multiplier times the minimum trading unit. The Exchanges have determined that the minimum unit of trading in IPs shall be 100 IPs, unless otherwise designated by the Exchange. OCC By-Laws, Article XVIII, Section 1.

quarterly basis. EIP holders could receive either the cash-out value or, under certain circumstances, physical delivery of shares of the component stocks of the S&P 500 Index or the Major Market Index. EIPs for which the delivery privilege has been exercised are referred to as "physical IPs" in OCC Rules. Specifically, the holder of one or more delivery units[12] that has not chosen to exercise the cash-out privilege has the right to obtain on each delivery time, which coincides with the quarterly cash-out time, the physical delivery of a proportionate number of shares of each stock comprising the underlying index, subject to certain conditions. A delivery fee established by the Amex would be charged to the EIP holder taking physical delivery of the component stocks.

Exercise notices requesting physical delivery of one or more delivery units will be assigned first, on a random basis, to those short EIP positions that have notified OCC of a desire to make physical delivery ("physical assignment volunteers"). If the number of delivery units for which holders have requested physical delivery exceeds the number of units made available for delivery by persons with short EIP positions, an Amex-designated "delivery facilitator" would assume responsibility for delivering the physical shares for such excess number of units.[13]

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[12] The term "delivery unit" regarding any class of physical IPs means the unit, consisting of the minimum number of trading units of such IPs specified by the Exchange, for which the delivery privilege may be exercised. The Amex has established the delivery unit as 500 minimum trading units for the S&P 500 Index and 250 minimum trading units for the XMI. OCC By-Laws, Article XVIII, Section 1. *See* Securities Exchange Act Release Nos. 26243 (November 2, 1988), 53 FR 45407, and 26355 (December 13, 1988), 53 FR 51181, for a detailed discussion of the physical delivery aspect of Amex's proposal.

[13] The delivery facilitator would be an OCC clearing member that is a member organization of the exchange. OCC By-Laws,

(Footnote continued on following page)

In proposing rules that would provide for the issuance, clearance, and settlement of IPs, OCC has, where appropriate, paralleled its existing rules and procedures. The proposal consists of a new Chapter XIX to OCC Rules applicable to IPs; amendments to Chapter VI dealing with margin; amendments to Chapter X to provide for a clearing fund contribution for IPs; revisions to the close-out provisions in Chapter XI; and conforming changes to Rules 207, 401 and 402 dealing with records and trade reporting. In addition, the proposal amends a number of OCC By-Laws and adds a new Article XVIII dealing exclusively with IPs.

A. Processing of IPs

OCC would process IP transactions in accordance with procedures that are substantially similar to OCC's well-established system for processing equity and non-equity option ("NEO") transactions. As discussed in more detail below, OCC would receive compared trade data from the exchanges, issue and (in the case of closing transactions) cancel the appropriate contracts. OCC would make appropriate book entries to clearing members' accounts representing the long and short positions in each account.[14] IP transactions would settle through OCC's existing systems on a next-day basis in same-day funds.[15] OCC would collect margin on short IP positions. As discussed below, CIPs, VIPs, and cer-

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[13] *continued*
Article XVIII, Section I. Initially, the Amex contemplates designating only one facilitator per EIP class and notes that the facilitator may be the specialist unit for that class of EIPs. *See* Securities Exchange Act Release No. 26355 (December 13, 1988), 53 FR 51181.

[14] IPs would be uncertificated securities.

[15] The proposed IP rules provide that OCC reserves the right to pay clearing members by issuance of an uncertified check for the net settlement amount.

tain EIPs are cash-settled. Therefore, OCC would process exercises and assignments according to procedures similar to those for NEO securities. On the other hand, certain EIPs provide the holder the right to physical delivery of the securities that comprise the index. Settlement of exercises and assignments regarding these physical IPs would be effected through designated stock clearing corporations.

For example, OCC's proposed system for processing exercises and assignments of the IP cash-out privilege generally parallels the system for processing exercises and assignments of NEO and equity securities. Specifically, clearing members exercising the cash-out privilege would tender exercise notices to OCC between 10:00 a.m. and 8:00 p.m. (Eastern Time)[16] on any day such exercises are permitted. In accordance with its existing procedures, OCC would accept all properly tendered exercise notices on the date of tender ("T") and would assign, pursuant to its procedures for random selection,[17] exercise notices in connection with the cash-out privilege submitted by exercising IP holders (or writers, in the case of two-way IPs) to clearing members with short positions (or long positions, in the case of two-way IPs) in that class of IP.

OCC would calculate the aggregate cash-out value[18] for each class of IPs on T+2 ("exercise settlement date") and would net the exercise settlement amounts to be paid by the

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[16] All times referred to herein are Eastern Time.

[17] *See* Securities Exchange Act Release No. 21899 (March 27, 1985), 50 FR 13444, approving OCC's revised random assignment procedures.

[18] Aggregate cash-out value is equal to the settlement index value (based on the opening trades of the index's component stocks on T+1) as reported by the exchange or the reporting service designated by the exchange, times the index multiplier times

(Footnote continued on following page)

clearing member against the exercise settlement amounts to be paid to the clearing member to obtain a single net settlement amount for IP exercises and assignments for each account of each clearing member. Prior to 8:00 a.m. on exercise settlement date, OCC would issue a report to clearing members advising them of their cash delivery and receive obligations. OCC would be authorized to draft clearing members' bank accounts at or before 10:00 a.m., and would be obligated to credit clearing members' bank accounts at or before 11:00 a.m., as appropriate, in satisfaction of net settlement amounts.

With respect to a feature of Amex EIPs, however, a holder could exercise the delivery privilege, instead of the cash-out privilege, by tendering an exercise notice to OCC between 10:00 a.m. and 8:00 p.m. on any day such exercises are permitted. Additionally, an EIP writing clearing member desiring to become, or acting on behalf of an EIP writer that desires to become, a physical assignment volunteer would tender to OCC a physical assignment volunteer notice between 10:00 a.m. and 8:00 p.m. on any day on which exercises are permitted regarding such IPs. Again, OCC would accept all properly tendered exercise notices and would accept properly tendered physical assignment volunteer notices to the extent they equal or are exceeded by the number of delivery units to which physical delivery exercise notices have been accepted by OCC. If the number of delivery units for which physical assignment volunteer notices were submitted was smaller than the number of physical delivery exercise notices tendered to OCC, OCC would randomly assign a suffi-

[18] *continued*

the minimum trading unit. If the settlement index value is not reported to OCC in a timely manner, OCC would be authorized to suspend settlement regarding that class of IPs and to fix a new exercise settlement date. The settlement index value as initially reported would be presumed to be accurate and would be final for purposes of calculating the aggregate cash-out value.

cient number of exercise notices in connection with the delivery privilege to non-volunteering physical IP writers to make up the imbalance. These writers would be required to pay to OCC the aggregate cash-out value on T+2. OCC then would notify the delivery facilitator,[19] before the opening of trading on the next business day, of the amount of the imbalance and it would buy the necessary shares to make up the baskets of deliverable stock in the opening transactions on the relevant markets.[20]

Delivery privilege exercises and assignment of delivery privilege exercises to physical assignment volunteers would be settled through the facilities of designated clearing corporations. Following the close of trading on the business day following the day on which delivery privilege exercise notices have been accepted by OCC, OCC would report the net amount of deliverable stock to be received or delivered to the designated clearing corporation of each clearing member. Clearing members making delivery would pay to OCC, and OCC would pay to the clearing member entitled to receive delivery, the entire "aggregate delivery value"[21] of each delivery unit on the morning of the sixth business day following the day on which a delivery privilege exercise notice is

[19] In the event that the agreement of a delivery facilitator to act as such, or the delivery facilitator's status as an OCC clearing member is terminated or suspended prior to the opening of trading on the trading day following the day on which an IP is exercised for delivery of stock, OCC would have the right to pay the cash-out value in lieu of stock to the extent that the exercise was assigned to the delivery facilitator rather than a volunteer writer.

[20] The delivery facilitator would buy at the opening because the aggregate cash-out value paid by non-volunteering physical IP writers would be based on the value of the underlying index calculated using opening values.

[21] Aggregate delivery value regarding a delivery unit of IPs refers to the value of such delivery unit, equal to the aggregate cash-out value times the delivery unit.

properly tendered to OCC ("T+6" or "exercise settlement date"). Under this method, each clearing member entitled to receive delivery would then pay its designated clearing corporation the appropriate price for each component stock on T+6.[22]

OCC has designed a new rule to deal with a feature unique to IPs—the dividend equivalent. Proposed Rule 1902 provides that the exchange notify OCC on each day prior to an IP dividend equivalent day the amount of the dividend equivalent to be received by IP holders and paid by IP writers on dividend equivalent day. The amount of the dividend equivalent is determined by the exchange on which the IP is traded based upon the regular cash dividends paid on stocks comprising the underlying index through the quarterly period. OCC, in turn, would notify clearing members prior to 8:00 a.m. on dividend equivalent day of their obligation to pay to OCC or to receive from OCC the net IP dividend equivalent.[23] The procedures for payments of dividend equivalents would conform to other settlement procedure provisions in OCC Rules, as discussed above.

B. Margin

As the issuer of IPs, OCC guarantees the performance of clearing member IP writers and holders. To collateralize this

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[22] Settlement at stock clearing corporations generally is by payment of certified check in clearinghouse (*i.e.*, next-day) funds.

[23] OCC would be obligated to pay clearing members that are entitled to dividend equivalents even if OCC does not receive a payment from a clearing member that owes OCC dividend equivalents. OCC would use the defaulting clearing member's margin deposits and clearing fund contribution to pay the amount of the dividend equivalent to the clearing member entitled to receive it. If a defaulting clearing member's margin deposit and clearing fund contribution are inadequate, OCC would assess pro rata all clearing members' clearing fund contributions to the NEO clearing fund.

guarantee in the event a clearing member defaults, OCC requires writing clearing members to, among other things, deposit margin with OCC.[24]

OCC generally would calculate clearing member margin requirements for short IP positions in a manner similar to that used for OCC's NEO margin system.[25] The NEO margin system has two components—premium margin, which can be a requirement or a credit, and additional margin. The term "premium margin" used in respect of IPs means the number of minimum trading units times the current highest asked price (or, in the case of exercised or assigned IP positions, times the aggregate current index value). "Additional margin" is calculated by determining assumed maximum one-day price movements in the underlying assets and projecting the effect of such movements on the liquidating value of the position on the basis of options pricing models.

Because IPs do not have an exercise price or expiration date, the "series" concept for option contracts would not apply. OCC would not differentiate among IPs based on the same underlying index, and a class group, *i.e.*, IPs based on the same underlying index, would include only one class of IPs. The proposal also would extend the product group concept to IPs, so that a class group consisting of a class of IPs may be margined on a combined basis with other class

[24] OCC's margin requirements apply only to OCC clearing members and should not be confused with the minimum margin that must be maintained in customer accounts as set by the exchanges in accordance with Regulation T of the Federal Reserve Board ("FRB").

[25] OCC's NEO margin system employs a portfolio evaluation methodology using options price theory to project the cost of liquidating a portfolio of positions in the event of an assumed "worst case" change in the price of the underlying interests. *See* Securities Exchange Act Release No. 23167 (April 22, 1986), 51 FR 16127, in which the Commission approved OCC's NEO margin system.

groups of IPs or index options, where OCC has determined that their respective underlying indexes exhibit sufficient price correlation to warrant such margin treatment. For example, a class group consisting of the XMI EIP would be combined with a class group consisting of the S&P 500 EIP, CIP and VIP for margin calculations because they both belong to the broad-based indexes product group.[26] Moreover, these class groups could be combined with index options such as the XMI option traded on the Amex, and the S&P 100 and S&P 500 Index options traded on the CBOE, because these, too, belong to the broad-based indexes product group.[27]

When writers assigned exercises of the cash-out privilege pay OCC the aggregate cash-out value on exercise settlement date on T+2, OCC would release margin held in respect of those positions. OCC would continue to require margin from clearing members with the obligation to deliver stock until exercise settlement day for physical delivery on T+6. The delivery facilitator, however, would be required only to post additional margin (*i.e.*, margin to cover OCC's exposure to an adverse market move during the day on which it was required to buy deliverable stock), and not premium margin because the assigned writers would be obligated to OCC for that amount, and that obligation would be secured by the margin deposits of those writers.[28] Because

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26 A haircut would be applied to additional margin credits to account for the lack of perfect correlation between class groups.

27 OCC would not provide margin credit for unsegregated long physical IP positions in a clearing member's customer's account as to which the delivery privilege has been exercised, on and after the second business day after tender of the exercise notice, because OCC would not be able to control the long value of the position on and after that day.

28 In effect, the delivery facilitator would receive a margin credit equal to the sum of the aggregate cash-out values paid to OCC in

(Footnote continued on following page)

IPs would be margined under OCC's NEO margin system, the proposal provides that each clearing member's contribution to the NEO clearing fund would be calculated on the basis of margin requirements for IPs as well as NEOs.[29]

The proposal also would extend OCC's Pledge Program to IPs thereby allowing clearing members to obtain financing by pledging long IPs as collateral to support loans from banks or other clearing members. Additionally, IPs would be eligible to be pledged from segregated (customer) accounts. In this regard, Phlx and Amex requested an interpretation from the FRB[30] that IPs be treated as equity securities for purposes of the relevant provisions of Regulation T.[31] Thus, the exchanges proposed that IPs be margined like common stock.[32] Accordingly, the FRB staff issued a letter not objecting to the commencement of IPs trading employing the proposed initial and maintenance margin for IPs.[33] Therefore, long IP positions in a customer account that constitute customer margin securities would be able to be pledged to secure obligations of the carrying broker to the same extent

[28] *continued*
connection with assignments of physical delivery exercises, because OCC would be holding that amount pending settlement with the delivery facilitator on exercise settlement day.

[29] Delivery facilitators would not be required to contribute to OCC's NEO clearing fund on account of their facilitating activities unless they otherwise carry IP or NEO positions.

[30] *See* letters to Laura Homer, Securities Credit Officer, FRB, from Richard T. Chase, Executive Vice President, Phlx, dated February 3, 1988, and from Gordon L. Nash, Senior Executive Vice President, Legal and Regulatory Affairs, Amex, dated March 8, 1989.

[31] *See* 12 C.F.R. §§ 220.5(c) and 220.18(a), (e), and (f) (1988).

[32] *See* Exchange approval order at 65-66.

[33] *See* letter from Laura Homer, Securities Credit Officer, FRB, to Richard Ketchum, Director, Division of Market Regulation, SEC, dated March 20, 1989.

as common stock.[34] Amendment No. 3 makes explicit that IPs could be transferred into and out of pledge accounts only in multiples of minimum trading units.

C. Suspension of an IP Clearing Member

The proposal would amend existing OCC Rules dealing with suspension of a clearing member to incorporate references to IPs. Because failure to pay a dividend equivalent or to meet settlement obligations with respect to IPs is necessarily a failure to meet a daily money obligation to OCC, OCC's proposed rules would provide for the application of its existing suspension rules and the disposition of settlement obligations through the Liquidating Settlement Account.[35] OCC would close out short IP positions[36] of a suspended clearing member, like uncovered short option positions, in the most orderly manner practicable. Any dividend equivalents that may be owed regarding short IP positions of a suspended clearing member would be withdrawn from the Liquidating Settlement Account. Proposed rule (sic) 1908 expressly would state that the suspension of a clearing mem-

[34] OCC's proposed rules require the clearing member to represent that all IPs pledged from customer accounts constitute margin securities. *See* OCC Rule 611.

[35] *See* OCC Rule 1104. The Liquidating Settlement Account is a special account created upon the suspension of an OCC clearing member. The account consists of the suspended clearing member's assets on deposit with OCC, including margin deposits, securities held in bulk, and that member's OCC clearing fund contributions. OCC closes out a suspended clearing member's outstanding obligations to OCC through transactions in this account.

[36] Currently, there are no "covered short IP positions" and the provisions of the rules that address these positions would have no effect. OCC has filed a separate rule change that would set out the requirements for IP escrow receipts. *See* Securities Exchange Act Release No. 26435 (January 10, 1989), 54 FR 1832. The Commission currently is reviewing this proposal.

ber in the course of cash-out privilege exercise settlement would not affect the settlement procedures applicable to other clearing members.

Proposed Rule 1908 would provide close-out procedures in the event a clearing member that is obligated to deliver stock fails to perform, or a clearing member that is entitled to receive deliverable stock is suspended before its designated clearing corporation becomes obligated to make settlement for the deliverable stock. In the former case, OCC would direct clearing members entitled to receive deliverable stock, *i.e.*, the clearing member matched against the non-performing clearing member in the stock trades reported to the stock clearing corporations, to buy in the stock for the account and liability of OCC, and settle the buy-in as quickly as possible after it occurred. In the latter case, OCC would direct delivering clearing members to sell out the deliverable stock and pay the proceeds of the sale to OCC.

The proposal also would amend OCC's By-Laws. Among other things, a new Article dealing with IPs provides definitions applicable to IPs, most of which parallel the definitions used regarding index options. The proposed Article also would set out the general rights and obligations of IP holders and writers. Additionally, in this Article OCC would reserve the right, on 30 days' notice, to exercise the cash-out privilege on behalf of all holders of a class of IPs, and thereby close out the market in that class, under certain extraordinary circumstances, *e.g.*, when there is a lack of regular trading activity in such class.

The proposal also would amend various OCC By-Laws to accommodate IPs. Among these changes, Article I would define "cleared security" to include IPs and would clarify that the terms "exercise" and "Exercising Clearing Member" can refer to exercise of the cash-out privilege in connection with IP transactions.

III. OCC's Rationale for the Proposed Rule Change

OCC believes the proposed rule change is consistent with the purposes and requirements of Section 17A of the Act because it would provide for the prompt and accurate clearance and settlement of transactions in IPs. OCC states in its filing that the proposed rule applies to IPs rules and procedures substantially similar to those that have been used in the clearance and settlement of transactions in equity and non-equity options. Moreover, OCC believes that the proposed rule change provides for the safeguarding of securities and funds in OCC's custody or control or for which OCC is responsible, in that it would apply to IPs a system of safeguards which is substantially the same as the system OCC currently uses for options.

IV. Discussion

For the reasons discussed below, the Commission is approving OCC's proposal. The Commission believes that OCC's proposal is consistent with Section 17A of the Act and OCC's obligation to promote the prompt and accurate clearance and settlement of securities transactions and to safeguard securities and funds in OCC's custody and control.[37]

Since the October 1987 market-break, a number of studies have recommended creating a market basket product.[38]

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[37] Several commentators expressed the belief that IPs are stock index futures, not securities. That issue is discussed in detail in the order approving the exchanges' proposal to trade IPs and, therefore, is not addressed in this order. This order incorporates the exchanges' approval order rationale for concluding that IPs are securities. *See* note 7, *supra*.

[38] *See, e.g.*, N. Katzenbach, *An Overview of Program Trading and Its Impact on Current Market Practices* (December 21, 1987) and Division of Market Regulation, *The October 1987 Market*

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These studies suggest that such a product could, among other things, ameliorate the volatility and steep price declines experienced during and since October 1987. These studies also focus on clearance and settlement of equities, options and futures, and the need to develop safe and efficient clearance and settlement systems both within and between markets. The latter focus is the subject of this filing and order.[39]

The Commission is satisfied that the proposed system for processing IP transactions is substantially similar to OCC's well-established system for processing NEO transactions. The Commission believes that use of that system is well designed to promote the prompt and accurate clearance and settlement of transactions in IPs consistent with Section 17A(b)(3) of the Act. With certain exceptions for physical IPs and IP dividend equivalent payments that will be discussed below (as well as the characteristics pertaining to the potential perpetual existence of IPs), the proposed system is identical to OCC's system for processing NEO transactions. For example, exchanges will use existing systems to report opening and closing trades in IPs to OCC. Additionally, OCC will maintain records and process opening and closing transactions,[40] will process exercise notices in connection with the

[38] *continued*
Break (February 1988) ("Staff Report"). *See also* Report of the Presidential Task Force on Market Mechanisms (January 1988) and the Interim Report of the Working Group on Financial Markets (May 1988) ("Working Group Report") for other recommendations arising out of the October 1987 market break.

[39] *See* Exchange approval order, *supra*, note 7, for a discussion of the benefits of a market basket product.

[40] Unlike NEOs where OCC collects the premium from IP purchasers and requires writers to post as margin the premium plus an additional margin amount, OCC would collect from IP purchas-

(Footnote continued on following page)

cash-out privilege, and will assign those exercises to OCC clearing members with IP positions on the other side of the market in accordance with existing procedures. Finally, OCC will effect net settlement each day with its clearing members for all IP and option transactions, including amounts owed in connection with dividend equivalents, pursuant to its well-established settlement procedures.

At least one market break report[41] noted that efforts to monitor clearing firm risk more effectively are critical to reducing risk and increasing confidence in the markets. In connection with this, the report emphasized the need for market participants to have access on a timely basis to information concerning the specific size and nature of their payment obligations so that they can make appropriate arrangements to fulfill them. In this regard, the Commission is concerned that clearing members know their IP dividend equivalent payment obligation in sufficient time to collect the payment from their customers or to arrange financing to meet that obligation. The Commission notes that although many of the indexes underlying IPs are well-established and widely disseminated, there are no arrangements for separately quoting the value of the dividend equivalent at this time. The Commission recognizes that the formulas for calculating the different index values will be set out in exchange rules and, therefore, a clearing member could compute the amount due with respect to each IP trading unit from published reports of dividends paid before dividend equivalent day. Nevertheless, the Commission urges OCC, in the months after IP trading commences, to monitor the abil-

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[40] continued
ers the aggregate index value and IP writers would be required to post (in the form of cash or other adequate collateral) the highest asked price or, for exercised or assigned IPs, the aggregate index value, plus an additional margin amount.

[41] *See* Working Group Report, *supra*, note 37.

ity of clearing members to meet their dividend equivalent obligations and to discuss with clearing members and the exchanges whether there is a need for earlier dissemination of IP dividend equivalent values.[42]

The Commission agrees with OCC that it is appropriate to include IPs in OCC's existing NEO margin system for OCC clearing members. Like NEOs, IPs generally are cash-settled.[43] In approving the NEO margin system,[44] the Commission determined that it provided a refined methodology for calculating margin, resulting in increased protection to OCC against adverse price movements in underlying assets. Additionally, recognizing that no margin system is designed to protect against the most extreme market moves, the Staff Report issued in connection with the October market break generally concluded that OCC's NEO margin system is a reliable method of risk measurement. Nevertheless, the Commission expects OCC to review and reassess periodically the NEO margin system and to make modifications, where appropriate, to deal safely with more volatile markets.[45]

The proposal also extends OCC's Pledge Program to proprietary and market maker IP positions. Thus, clearing

[42] Based on experience regarding the actual settlement of IP dividend equivalent obligations, the Commission will review whether the exchanges should make available, on a routine basis, information regarding estimated or accrued dividend equivalents.

[43] Physical IPs, which are settled by delivery of the component stocks in the underlying index, are discussed below.

[44] *See, supra*, note 25.

[45] OCC recently completed a review of its margin system. *See* OCC, The Backup System: A Special Study by the Margin Committee Subcommittee (August 31, 1988). The subcommittee's report contains a number of recommendations concerning OCC's margin policies and practices. The Commission understands that OCC's Board of Directors is considering those recommendations and will implement many in the near future.

members will be able to pledge IP positions maintained in proprietary and market maker accounts to lenders.[46] Additionally, because the FRB has determined that IPs may be treated as margin securities under Regulation T, the proposal would extend OCC's Pledge Program to IP positions in customer accounts.[47] The Commission supports this extension of the Pledge Program because it provides clearing members the ability to obtain additional financing through the pledge of customer IP positions maintained in margin accounts. Moreover, the Commission believes that use of OCC facilities to conduct this pledge activity should provide greater certainty to banks financing clearing member, broker-dealer, and customer IP positions.

The Commission notes that, unlike OCC rules dealing with NEOs, the proposed IP rules provide OCC the authority to exercise the cash-out privilege for an entire class of IPs on thirty days' notice to IP holders and writers in certain limited, extraordinary circumstances. For example, such circumstances would include, but are not limited to, a lack of regular trading activity in a class of IPs or the impending termination of business on the part of OCC or the exchange on which that class of IPs is traded. The Commission agrees with OCC that it should have the ability to terminate a class of IPs under extraordinary circumstances because, unlike options which expire at a pre-established time, IPs are of unlimited duration. The Commission recognizes that in certain circumstances OCC may want to act expeditiously to

[46] OCC's Pledge Program is a convenient mechanism for processing pledge loans to clearing members because OCC will recognize the pledgee's interest in pledge positions. *See* Securities Exchange Act Release Nos. 24171 (March 4, 1987), 52 FR 7724; 22278 (July 30, 1985), 50 FR 31804; 20994 (May 25, 1984), 49 FR 23132; and 19956 (July 19, 1983), 48 FR 33956.

[47] Long option positions, although they can be paired with short options to reduce margin requirements, currently have no loan value for purposes of Regulation T.

close out a class of IPs. Nevertheless, the Commission notes that OCC's By-Laws authorize OCC to exercise the cash-out privilege on a *minimum* of thirty days' notice. The Commission believes this period provides sufficient notice to allow market participants to make any needed adjustments to other related securities or futures positions. Nevertheless, given the extraordinary nature of a mandatory cash-out, the Commission expects OCC to make every effort to provide more than thirty days' notice where possible.

The Amex EIP provides holders exercising the delivery privilege the ability to obtain the basket of securities underlying either the XMI or the S&P 500 Index, thus creating a mechanism for the delivery of a standardized portfolio of equity securities. An EIP holder exercising the delivery privilege could obtain shares in as many as 500 companies. To otherwise establish such a portfolio would require the purchase of 500 different securities.

OCC will process exercises of the delivery privilege in a manner similar to that used for individual equity options with some modifications to reflect the unique characteristics of EIPs. For example, OCC will report EIP matched trade information to the designated clearing corporation reflecting the right of the exercising clearing member to receive shares in each of the component stocks underlying the EIP index and the obligation of either the delivery facilitator or a volunteering writing clearing member, as contra party to the exercising clearing member, to deliver an equal amount of shares in each of the component stocks. Because matched EIP trades will be processed in the designated clearing corporation's continuous net settlement ("CNS") system,[48] the

[48] CNS uses the system price (usually the previous days' reported closing price) to price members' payment obligations. Delivery and receive obligations are adjusted on a daily basis by a mark-to-the-

(Footnote continued on following page)

designated clearing corporation will step between the exercising clearing member and the contra party and, in place of OCC, will guarantee those deliveries. Thus, clearing members will be able to net deliver and receive obligations in connection with physical EIP exercises with other activity in the underlying component stocks. Nevertheless, because the designated clearing corporations' CNS systems require clearing members to pay market value for securities delivered to them and pays to delivering clearing members the market value of securities they deliver (in satisfaction of their CNS delivery obligations), OCC must provide funds to the clearing member who will receive securities from the designated clearing corporation (*i.e.*, the exercising clearing member) so that the exercising clearing member can pay the designated clearing corporation and the designated clearing corporation can pay the delivering clearing member (*i.e.*, either the delivery facilitator or a volunteering EIP writer). Because the clearing member exercising the EIP physical delivery privilege previously paid the full value of the index for the right to receive the components stocks, OCC and the designated clearing corporations have converted a free delivery obligation into a delivery against payment or receipt against payment obligation.

The Commission believes it is appropriate to settle exercises of physical EIPs in this manner because it is consistent with one-account settlement.[49] The conversion of a free de-

[48] *continued*
market. Thus, by paying a mark-to-the-market, a clearing member with a right to receive can use that long position to offset a delivery obligation that will arise tomorrow. In CNS, every right to receive carries the obligation to pay, and every obligation to deliver carries the right to receive the system price.

[49] Section 17A requires the Commission to facilitate the development of a national clearance and settlement system. One feature

(Footnote continued on following page)

livery obligation into a delivery against payment obligation, however, raises two concerns about cash flows. The proposed process for settling EIP delivery privilege exercises requires coordinated funds flow among many parties. The Commission notes that, in such a system, there is a risk of default by persons holding funds pending completion of the delivery process.[50] The Commission acknowledges OCC's representations[51] that discussions are underway with the designated clearing corporations to develop a more simple process for settling exercises of physical EIPS. Nevertheless, the Commission believes it is imperative, within the months after IP trading commences, for OCC and the designated clearing corporations to design a system through which OCC can pay directly to the designated clearing corporation cash that would otherwise be paid to the exercising clearing member (perhaps using the margin deposits posted by the assigned EIP holders) on behalf of the exercising

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[49] *continued*

of such a system is one-account settlement, *i.e.*, the ability to clear and settle through one entity all securities trades, regardless of the location of the other party to the trade or the market in which the trade is executed.

[50] For example, generally only broker-dealers hold memberships in OCC and designated clearing corporations, *e.g.*, National Securities Clearing Corporation ("NSCC"). Therefore, a large institution that maintains EIP positions must rely on the creditworthiness of a broker-dealer in converting its EIP positions to a portfolio of the underlying securities. If the broker-dealer clearing member fails while processing EIP exercises on behalf of the institutional customer and losses exceed Securities Investor Protection Corporation ("SIPC") insurance limits, that institution may suffer financial loss. Instead of having an identifiable interest in the underlying securities or the EIPs, the institution may share pro rata with all other customers in the pool of customer property maintained by the broker-dealer.

[51] Telephone conversation between Judith Poppalardo, Attorney, SEC, and James R. McDaniel, Schiff Hardin & Waite, on February 3, 1989.

clearing member, which would entitle the exercising clearing member to receive securities, subject to daily marks-to-the-market, without payment or delivery.[52]

On the basis of the foregoing, the Commission finds that OCC's proposed rule change is consistent with the Act and, in particular, with Section 17A of the Act.

Accordingly, IT IS THEREFORE ORDERED, under Section 19(b)(2) of the Act, that the proposal (File No. SR-OCC-88-02) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

JONATHAN G. KATZ
Secretary

Dated: April 11, 1989

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[52] Such a system exists today at at least one designated clearing corporation albeit for different purposes. *See* Securities Exchange Act Release No. 25107 (October 1, 1987), 52 FR 43959 (approving a recent NSCC rule change that would allow an NSCC-Depository Trust Company ("DTC") member to instruct NSCC to charge the member's settlement account for 130% of the value of securities the member anticipated borrowing, but, in fact, did not receive. NSCC would segregate these funds in a fully paid-for account. This protects an NSCC-DTC member who makes a security delivery in anticipation of borrowing stock from being out of compliance with Rule 15c3-3 under the Act [the customer protection rule], if the stock is not borrowed).

APPENDIX D

In the

United States Court of Appeals

For the Seventh Circuit

Nos. 89-1538, 89-1763, 89-1786, and 89-2012

CHICAGO MERCANTILE EXCHANGE, BOARD OF TRADE OF THE CITY OF CHICAGO, and INVESTMENT COMPANY INSTITUTE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent,

and

PHILADELPHIA STOCK EXCHANGE, INC., OPTIONS CLEARING CORPORATION, AMERICAN STOCK EXCHANGE, INC., and CHICAGO BOARD OPTIONS EXCHANGE, INC.,

Intervening Respondents.

On Petitions for Rehearing and
Suggestions of Rehearing En Banc

DECIDED OCTOBER 23, 1989

Before BAUER, *Chief Judge*, EASTERBROOK, *Circuit Judge*, and FAIRCHILD, *Senior Circuit Judge*.

PER CURIAM. The petition for rehearing filed by the Securities and Exchange Commission relies on a portion of 7 U.S.C. §2 added by the Accord legislation of 1982. This language provides:

> [E]xcept as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission . . . or (ii) restrict the Securities and Exchange Commission . . . from carrying out [its] duties and responsibilities in accordance with such laws.

As the Commission observes, our opinion did not discuss this part of the statute. We had not overlooked this text but rather had concluded that it afforded the SEC no comfort.

Although the Commission's jurisdiction continues "except as hereinabove provided", what is "provided" immediately above in §2 is that "the [CFTC] shall have exclusive jurisdiction . . . with respect to . . . transactions involving contracts of sale of a contract for future delivery, traded or executed on a contract market . . . or any other board of trade, exchange, or market". If IPs are futures contracts, then the CFTC has exclusive jurisdiction, the "except" clause applies, and the remainder of the language on which the SEC now relies has no force. It reminds us that the CFTC does not have powers Congress did not confer—that §2 carries no implicit preemptive force—but it does not help answer the question whether a given instrument is a futures contract.

The SEC's remaining arguments in support of rehearing flow from the proposition that IPs are equivalent to securities portfolios from the perspectives of the longs. Our opinion conceded as much, while observing that IPs just as surely look like futures contracts from the perspective of the shorts. Neither of these is the "privileged" perspective, and it is inappropriate to emphasize one over the other in order to direct jurisdiction to one agency rather than the other. This duality is one of the principal ingredients in our conclusion that IPs are both securities and futures contracts. IPs are investment vehicles as longs see things; yet IPs are not capital-*raising* vehicles, given the nature of the shorts' commitments. Congress might

think it wise to relax the exclusivity clause that lies at the heart of this dispute; so long as that clause remains, however, jurisdictional clashes of the sort represented here are inevitable, and the need to draw a line does not suggest that the first agency to assert jurisdiction ought to be the winner.

The Philadelphia Stock Exchange takes issue with note 3 of our opinion, which said that "none of the parties to the case suggests that the Philadelphia's product should be treated differently" because of its daily cash-out-at-a-penalty feature. Our observation may be misleading. Page 12 of the Philadelphia's reply brief states:

> [I]t is important to note that [our IP] has a daily, not quarterly, cash-out provision. Therefore, assuming *arguendo* as true the CME's and CBT's notion that a quarterly cash-out carries with it an element of futurity, a daily cash-out cannot be equated with a futures contract's quarterly expiration. Even in a stock transaction, the settlement period for delivery of the stock is 5 days. A daily cash-out, which is a feature unique to [our IP], eliminates any element of futurity.

This statement, in passing in a reply brief, does not come to grips with the fact that the Philadelphia's daily cash-out feature carries a penalty; 100% cash-out may be achieved only by waiting for the quarterly date. Deferred settlement of an ordinary stock trade occurs at a price fixed on the date of the trade; IPs are valued as of a future date. No party argued that daily cash out *at a penalty* eliminates all elements of futurity from the IP. We did not consider, and we do not decide the appropriate classification of, an IP with a daily cash-out feature at no penalty.

None of the other arguments in the petitions for rehearing requires further comment. The petitions are denied. A judge in active service called for a vote on the suggestions of rehearing en banc, which failed to attain a majority. Judges Cudahy and Ripple voted to rehear the case

en banc. Judge Flaum took no part in the consideration or decision of this case.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

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APPENDIX E

STATUTES AND REGULATIONS INVOLVED

Commodity Exchange Act (the "CEA"), as amended, 7 U.S.C. §§ 1-26 (1988)

Section 2(a)(1)(A) of the CEA, 7 U.S.C. § 2 (1988)

§ 2. Definitions

For the purposes of this chapter "contract of sale" shall be held to include sales, agreements of sale, and agreements to sell. The word "person" shall be construed to import the plural or singular, and shall include individuals, associations, partnerships, corporations, and trusts. The word "commodity" shall mean wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in section 13-1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in: *Provided,* That the Commission shall have exclusive jurisdiction, except to the extent otherwise provided in section 2a of this title, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 7 of this

title or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 23 of this title: *And provided further,* That, except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State. Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade. The term "future delivery," as used in this chapter, shall not include any sale of any cash commodity for deferred shipment or delivery. The words "board of trade" shall be held to include and mean any exchange or association, whether incorporated or unincorporated, of persons who shall be engaged in the business of buying or selling any commodity or receiving the same for sale on consignment. The words "interstate commerce" shall be construed to mean commerce between any State, Territory, or possession, or the District of Columbia, and any place outside thereof; or between points within the same State, Territory, or possession, or the District of Columbia, but through any place outside thereof, or within any Territory or possession, or the District of Columbia. The words "cooperative association of producers" shall mean any cooperative association, corporate or otherwise, not less than 75 per centum in good faith owned or controlled, di-

rectly or indirectly, by producers of agricultural products and otherwise complying with sections 291 and 292 of this title, including any organization acting for a group of such associations and owned or controlled by such associations, provided that business done for or with the United States of America, or any agency thereof, shall not be considered either member or nonmember business in determining the compliance of any such association with said sections. The words "member of a contract market" shall mean and include individuals, associations, partnerships, corporations, and trusts owning or holding membership in, or admitted to membership representation on, a contract market or given members' trading privileges thereon. The words "futures commission merchant" shall mean and include individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom. The term "introducing broker" shall mean any person, except an individual who elects to be and is registered as an associated person of a futures commission merchant, engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market who does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result thereform. The words "floor broker" shall mean any person who, in or surrounding any "pit", "ring," "post", or other place provided by a contract market for the meeting of person similarly engaged, shall purchase or sell for any other person any commodity for future delivery on or subject to

the rules of any contract market. The words "the Commission" shall mean the Commodity Futures Trading Commission established under section 4a of this title. The term "commodity trading advisor" shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading in any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market, any commodity option authorized under section 6c of this title, or any leverage transaction authorized under section 23 of this title, or who, for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the foregoing; but such term does not include (i) any bank or trust company or any person acting as an employee thereof, (ii) any news reporter, news columnist, or news editor of the print or electronic media, or any lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (vi) the publisher or producer of any print or electronic data of general and regular dissemination, including its employees, (v) the fiduciary of any defined benefit plan which is subject to the provisions of the Employee Retirement Income Security Act of 1974 [29 U.S.C.A. § 1001 et seq.], (vi) any contract market, and (vii) such other persons not within the intent of this definition as the Commission may specify by rule, regulation, or order: *Provided*, That the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or profession: *Provided further*, That the Commission, by rule or regulation, may include within this definition, any person advising as to the value of commodities or issuing reports or analyses concerning commodities, if the Commission determines that such rule or regulation will effectuate the purposes of this provision. The term "commodity pool operator"

shall mean any person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons not within the intent of this definition as the Commission may specify by rule or regulation or by order.

* * *

Section 2(a)(1)(B) of the CEA, 7 U.S.C. § 2a (1988)

§ 2a. Designation of boards of trade as contract markets; approval by and jurisdiction of Commodity Futures Trading Commission and Securities and Exchange Commission

Notwithstanding any other provision of law—

(i) This chapter shall not apply to and the Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities (as defined in sections 77b(1) or 78c(a)(10) of Title 15 on January 11, 1983), including any group or index of such securities, or any interest therein or based on the value thereof.

(ii) This chapter shall apply to and the Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty") and transactions involving, and may designate a board of trade as a contract market in, contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the

value thereof): *Provided, however,* That no board of trade shall be designated as a contract market with respect to any such contracts of sale (or options on such contracts) for future delivery unless the board of trade making such application demonstrates and the Commission expressly finds that the specific contract (or option on such contract) with respect to which the application has been made meets the following minimum requirements:

(I) Settlement of or delivery on such contract (or option on such contract) shall be effected in cash or by means other than the transfer or receipt of any security, except an exempted security under sections 77c or 78c(a)(12) of Title 15 as in effect on January 11, 1983 (other than any municipal security, as defined in section 78c(a)(29) of Title 15 as in effect on January 11, 1983);

(II) Trading in such contract (or option on such contract) shall not be readily susceptible to manipulation of the price of such contract (or option on such contract), nor to causing or being used in the manipulation of the price of any underlying security, option on such security or option on a group or index including such securities; and

(III) Such group or index of securities shall be predominately composed of the securities of unaffiliated issuers and shall be a widely published measure of, and shall reflect, the market for all publicly traded equity or debt securities or a substantial segment thereof, or shall be comparable to such measure.

(iii) Upon application by a board of trade for designation as a contract market with respect to any contract of sale (or option on such contract) for future delivery involving a group or index of securities, the Commission shall provide an opportunity for public comment on whether such contracts (or options on such contracts) meet the minimum requirements set forth in clause (ii) of this subparagraph.

(iv)(I) The Commission shall consult with the Securities and Exchange Commission with respect to any application which is submitted by a board of trade before December 9, 1982, for designation as a contract market with respect

to any contract of sale (or option on such contract) for future delivery of a group or index of securities. If, no later than fifteen days following the close of the public comment period, the Securities and Exchange Commission shall object to the designation of a board of trade as a contract market in such contract (or option on such contract) on the ground that any minimum requirement of clause (ii) of this subparagraph is not met, the Commission shall afford the Securities and Exchange Commission an opportunity for an oral hearing, to be transcribed, before the Commission, and shall give appropriate weight to the views of the Securities and Exchange Commission. Such oral hearing shall be held after the public comment period, prior to Commission action upon each designation, and not less than thirty nor more than forty-five days after the close of the public comment period, unless both the Commission and the Securities and Exchange Commission otherwise agree. If such an oral hearing is held, the Securities and Exchange Commission fails to withdraw its objections, and the Commission issues an order designating a board of trade as a contract market with respect to any such contract (or option on such contract), the Securities and Exchange Commission shall have the right of judicial review of such order in accordance with the standards of section 9 of this title. If, pursuant to sections 8 and 9 of this title, there is a hearing on the record with respect to such application for designation, the Securities and Exchange Commission shall have the right to participate in that hearing as an interested party.

(II) Effective for any application submitted by a board of trade on or after December 9, 1982, for designation as a contract market with respect to any contract of sale (or option on such contract) for future delivery of a group or index of securities, the Commission shall transmit a copy of such application to the Securities and Exchange Commission for review. The Commission shall not approve any such application if the Securities and Exchange Commission determines that such contract (or option on such contract) fails to meet the minimum requirements set forth in clause (ii) of this subparagraph. Such determination shall

be made by order no later than forty-five days after the close of the public comment period under clause (iii) of this subparagraph. In the event of such determination, the board of trade shall be afforded an opportunity for a hearing on the record before the Securities and Exchange Commission. If a board of trade requests a hearing on the record, the hearing shall commence no later than thirty days following the receipt of the request, and a final determination shall be made no later than thirty days after the close of the hearing. A person aggrieved by any such order of the Securities and Exchange Commission may obtain judicial review thereof in the same manner and under such terms and conditions as are provided in section 8 of this title.

(v) No person shall offer to enter into, enter into, or confirm the execution of any contract of sale (or option on such contract) for future delivery of any security, or interest therein or based on the value thereof, except an exempted security under sections 77c or 78c(a)(12) of Title 15 as in effect on January 11, 1983 (other than any municipal security as defined in section 78c(a)(29) of Title 15 on January 11, 1983), or except as provided in clause (ii) of this subparagraph, any group or index of such securities or any interest therein or based on the value thereof.

* * *

Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§ 78a-7*ll* (1988)

Section 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10) (1988)

§ 78c. Definitions and application

(a) Definitions

When used in this chapter, unless the context otherwise requires—

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil,

gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

* * *

Section 9(g) of the Exchange Act, 15 U.S.C. § 78i(g) (1988)

§ 78i. Manipulation of security prices

(g) Foreign currencies

Notwithstanding any other provision of law, the Commission shall have the authority to regulate the trading of any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency (but not, with respect to any of the foregoing, an option on a contract for future delivery).

* * *

Section 25(a) of the Exchange Act, 15 U.S.C. § 78y(a) (1988)

§ 78y. Court review of orders and rules

Final Commission orders; persons aggrieved; petition; record; findings; affirmance, modification, enforcement, or setting aside of orders; remand to adduce additional evidence

(a)(1) A person aggrieved by a final order of the Commission entered pursuant to this chapter may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.

(2) A copy of the petition shall be transmitted forthwith by the clerk of the court to a member of the Commission or an officer designated by the Commission for that purpose. Thereupon the Commission shall file in the court the record on which the order complained of is entered, as provided in section 2112 of Title 28 and the Federal Rules of Appellate Procedure.

(3) On the filing of the petition, the court has jurisdiction, which becomes exclusive on the filing of the record, to affirm or modify and enforce or to set aside the order in whole or in part.

(4) The findings of the Commission as to the facts, if supported by substantial evidence, are conclusive.

(5) If either party applies to the court for leave to adduce additional evidence and shows to the satisfaction of the court that the additional evidence is material and that there was reasonable ground for failure to adduce it before the Commission, the court may remand the case to the Commis-

sion for further proceedings, in whatever manner and on whatever conditions the court considers appropriate. If the case is remanded to the Commission, it shall file in the court a supplemental record containing any new evidence, any further or modified findings, and any new order.

* * *

Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a) (1988)

§ 78bb. Effect on existing law

(a) Addition of rights and remedies; recovery of actual damages; State securities commissions

The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder. No State law which prohibits or regulates the making or promoting of wagering or gaming contracts, or the operation of "bucket shops" or other similar or related activities, shall invalidate any put, call, straddle, option, privilege, or other security, or apply to any activity which is incidental or related to the offer, purchase, sale, exercise, settlement, or closeout of any such instrument, if such instrument is traded pursuant to rules and regulations of a self-regulatory organization that are filed with the Commission pursuant to section 78s(b) of this title.

* * *

Rules and Regulations Under the Securities Exchange Act of 1934

Rule 9b-1, 17 C.F.R. § 240.9b-1 (1989)

§ 240.9b-1 Options disclosure document

(a) *Definitions.* The following definitions shall apply for the purpose of this rule.

(1) "Options market" means a national securities exchange, an automated quotation system of a registered securities association or a foreign securities exchange on which standardized options are traded.

(2) "Options class" means all options contracts covering the same underlying instrument.

(3) "Options disclosure document" means a document prepared by one or more options markets which contains the information required by this rule with respect to the options classes covered by the document.

(4) "Standardized options" are options contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relate to options classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.

(b)(1) Five preliminary copies of an options disclosure document containing the information specified in paragraph (c) of this section shall be filed with the Commission by an options market at least 60 days prior to the date definitive copies are furnished to customers, unless the commission determines otherwise having due regard to the adequacy of the information disclosed and the public interest and protection of investors. Five copies of the definitive options disclo-

sure document shall be filed with the Commission not later than the date the options disclosure document is furnished to customers. Notwithstanding the above, the use of an options disclosure document shall not be permitted unless the options class to which such document relates is the subject of an effective registration statement on Form S-20 under the Securities Act.

(2)(i) If the information contained in the options disclosure document becomes or will become materially inaccurate or incomplete or there is or will be an omission of material information necessary to make the disclosure document not misleading, the options market shall amend its options disclosure document by filing five copies of an amendment to such document with the Commission at least 30 days prior to the date definitive copies are furnished to customers, unless the Commission determines otherwise having due regard to the adequacy of the information disclosed and the public interest and protection of investors. Five copies of the definitive options disclosure document, as amended, shall be filed with the Commission not later than the date the amended options disclosure document is furnished to customers.

(ii) Notwithstanding paragraph (b)(2)(i) of this section, an options market may distribute such materials prior to such 30-day period if it determines, in good faith, that such delivery is necessary to ensure timely and accurate disclosure with respect to the subject standardized options contracts. Five copies of any amendment distributed pursuant to this paragraph shall be filed with the Commission at the time of distribution. In that instance, if the Commission determines, having given due regard to the adequacy of the information disclosed and the public interest and the protection of investors, it may require refiling of the amendment pursuant to paragraph (b)(2)(i) of this Rule.

(c) *Information required in an options disclosure document.* An options disclosure document shall contain the following information, unless otherwise provided by the Commission, with respect to the options classes covered by the document:

(1) A glossary of terms;

(2) The mechanics of buying, writing and exercising the options, including settlement procedures;

(3) The risks of trading the options;

(4) The market for the options;

(5) A brief reference to the transaction costs, margin requirements and tax consequences of options trading;

(6) Identification of the issuer of the options;

(7) Identification of the instrument or instruments underlying the options class; and

(8) The registration of the options on Form S-20 and the availability of the prospectus and the information in Part II of the registration statement; and

(9) Such other information as the Commission may specify.

(d) *Broker-dealer obligations.* (1) No broker or dealer shall accept an order from a customer to purchase or sell an option contract relating to an options class that is the subject of an options disclosure document, or approve the customer's account for the trading of such option, unless the broker or dealer furnishes or has furnished to the customer the options disclosure document.

(2) If an options disclosure document is amended, each broker and dealer shall promptly send the information contained in the definitive amendment to each customer whose account is approved for trading the options class(es) to which the options disclosure document relates.

3 2

Nos. 89-1502, 89-1503

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

AMERICAN STOCK EXCHANGE, INC., CHICAGO BOARD OPTIONS EXCHANGE, INCORPORATED, THE OPTIONS CLEARING CORPORATION, AND PHILADELPHIA STOCK EXCHANGE, INC.,

Petitioners,

v.

CHICAGO MERCANTILE EXCHANGE, BOARD OF TRADE OF THE CITY OF CHICAGO, INVESTMENT COMPANY INSTITUTE, AND SECURITIES AND EXCHANGE COMMISSION,

Respondents.

BRIEF IN OPPOSITION OF RESPONDENTS CHICAGO MERCANTILE EXCHANGE AND BOARD OF TRADE OF THE CITY OF CHICAGO

MARK D. YOUNG
GARRETT B. JOHNSON
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5084

Counsel for Respondent Board of Trade of the City of Chicago

JERROLD E. SALZMAN
Counsel of Record
JAMES T. MALYSIAK
FREEMAN, FREEMAN & SALZMAN, P.C.
Suite 2700
401 North Michigan Avenue
Chicago, Illinois 60611
(312) 222-5100

Counsel for Respondent Chicago Mercantile Exchange

Midwest Law Printing Co., Chicago 60611, (312) 321-0220

QUESTION PRESENTED

Did the Court of Appeals correctly hold that the instruments known as Index Participations are stock index futures contracts and therefore subject to the exclusive regulatory jurisdiction of the Commodity Futures Trading Commission under the Commodity Exchange Act?

LIST OF PARTIES

The parties in the Court of Appeals were:

The Chicago Mercantile Exchange
The Board of Trade of the City of Chicago
The Philadelphia Stock Exchange, Inc.
The American Stock Exchange, Inc.
The Options Clearing Corporation
The Chicago Board Options Exchange
The Investment Company Institute
The Securities and Exchange Commission
The Commodity Futures Trading Commission
(as *amicus curiae*)

Pursuant to this Court's Rule 29.1, respondents Chicago Mercantile Exchange and Board of Trade of the City of Chicago state that they are membership corporations and are wholly owned by their members. They have no parent corporations and no subsidiaries which are not wholly owned by them.

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CHICAGO MERCANTILE EXCHANGE, BOARD OF TRADE OF THE CITY OF CHICAGO, INVESTMENT COMPANY INSTITUTE, AND SECURITIES AND EXCHANGE COMMISSION,

Respondents.

BRIEF IN OPPOSITION OF RESPONDENTS CHICAGO MERCANTILE EXCHANGE AND BOARD OF TRADE OF THE CITY OF CHICAGO

Respondents Chicago Mercantile Exchange ("CME") and the Board of Trade of the City of Chicago ("Board of Trade") oppose the certiorari petitions filed by the American Stock Exchange, Inc. ("AMEX"), Chicago Board Options Exchange ("CBOE"), and The Options Clearing Corporation ("OCC") in No. 89-1502 and the Philadelphia Stock Exchange, Inc. ("PHLX") in No. 89-1503. The CME and Board of Trade file this consolidated brief in opposition.

The petitions provide no adequate reason for this Court to grant certiorari and should be denied because:

1. The Seventh Circuit's decision is correct. Index Participations ("IP's") are stock index futures contracts subject to the exclusive regulatory jurisdiction of the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act. As such, the CFTC's jurisdiction over IP's supersedes any authority the Securities and Exchange Commission ("SEC") might otherwise have had.

2. Petitioners grossly exaggerate the consequences of the Seventh Circuit decision. The decision neither blurs the distinctions between securities and futures contracts nor stifles innovation in the financial markets.

3. The policy issue raised by the petitions—whether the CFTC should continue to have exclusive jurisdiction over stock index futures—is currently under active review by Congress. Congress chose to give the CFTC this exclusive jurisdiction and Congress alone should decide whether to adjust this jurisdictional assignment.

RELEVANT STATUTES

Pursuant to Section 2(a)(1)(A) and (B) of the Commodity Exchange Act, 7 U.S.C. §§ 2, 2a (Joint Appendix of Petitioners ("App.") 112-119), the CFTC has exclusive jurisdiction over all futures contracts, including specifically stock index futures.

Under Section 9(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78i(g) (App. 120), the SEC has exclusive jurisdiction over stock index options.

The definition of "security" is found in Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (App. 119-120).

STATEMENT OF THE CASE

Proceedings Below

During 1988, PHLX, AMEX, and the CBOE filed with the SEC proposed rule changes seeking SEC approval to trade IP's. During each of the public comment periods on the proposed rule changes, the CFTC advised the SEC that the CFTC had determined that IP's were stock index futures within the CFTC's exclusive jurisdiction and that the SEC lacked authority to regulate IP's. The CME and Board of Trade filed similar objections.

The SEC's Decision

Notwithstanding the CFTC's view, the SEC concluded that it had jurisdiction over IP's primarily because the SEC found that IP's sufficiently resembled stock to constitute "stock" within the definition of "security" in Section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. § 78c(a)(10), App. 49-52. In addition, the SEC deemed an IP to be a "security" under other components of the statutory definition of that term. *Id.* at 50, 52. Although urged to do so by AMEX, the SEC did not adopt the view that IP's were stock index options, a type of security over which Congress had vested exclusive jurisdiction in the SEC. *Id.* at 52 n. 57.

Giving no weight or deference to the CFTC's determination, the SEC also ruled that IP's were not stock index futures contracts. Instead of relying upon the CFTC's construction of its enabling statute, the SEC issued its own different construction of the Commodity Exchange Act and ruled that IP's lack the "futurity" and "bilateralism"

that the SEC decided were requisites of futures contracts. App. 53-63.

The Court of Appeals Decision

The CME and Board of Trade petitioned for review to the Seventh Circuit, where the CFTC appeared as *amicus curiae*. The Seventh Circuit unanimously set aside the SEC's order because the SEC lacked jurisdiction over IP's. Having analyzed both the SEC's and CFTC's interpretations of the relevant statutes as applied to IP's, the Court of Appeals held that the CFTC had exclusive jurisdiction over IP's.

Initially, the Court of Appeals disposed of the SEC's claim that IP's were akin to "stock." App. 14-15. The Court of Appeals emphasized:

> IPs are not stock *in* anything. . . . Stock is an equity interest in an issuer, the residual claim to the profits of a venture. . . . Purchasers of IPs don't own equity, directly or indirectly. . . . *Id.*; emphasis in original.

Moreover, the Seventh Circuit observed that, although IP's "do not fit comfortably into the other pigeonholes of [the definition of security in] § 3(a)(10)," there was a "basis for drawing IPs within § 3(a)(10), even though they do not duplicate a recognized category." *Id.* at 15.

The Court of Appeals next analyzed whether IP's were futures contracts, as the CFTC maintained. First, the Seventh Circuit dismissed the SEC's claim that IP's lacked the "futurity" of futures contracts.

> [T]he SEC is wrong. IPs are no more a "present obligation to pay current value" than are futures contracts. The holder of either an IP or

> a stock-index futures contract may go to market and trade it; the price necessarily tracks current value. App. 16.

The Court of Appeals considered IP's and futures from the perspectives of the buyers (longs) and sellers (shorts). The Court of Appeals found that "from the long's point of view, IP and futures contract ultimately look the same" (*id.* at 17), while "[s]horts on IPs make the same pledge as shorts on stock index futures contracts. . ." (*id.* at 16). Upon completing this analysis, the Court of Appeals noted the conflicting agency interpretations and reasoned:

> If each agency's interpretation of its own statute is entitled to some deference, then the IP is both a security and a futures contract. It has some attributes of both, and all attributes of neither, as we have laid out in excessive detail. Neither characterization can be called wrong. *Id.* at 20.

The Court of Appeals then applied the exclusive jurisdiction provision in Section 2(a)(1)(B)(ii) of the Commodity Exchange Act, 7 U.S.C. 2a(ii), and held that the SEC had no jurisdiction to approve or regulate IP's:

> An instrument either is or is not a futures contract. If it is, the CFTC has jurisdiction; if it is not, the CFTC lacks jurisdiction; if the CFTC has jurisdiction, its power is exclusive. *Id.* at 21.

The Court also explained that if IP's were stock index options, the SEC's authority over those instruments could have trumped the CFTC's exclusive jurisdiction. *Id.* at 14. Like the SEC and CFTC, the Court of Appeals did not find IP's to be options. *Id.* at 17-18. Thus, the Court

of Appeals set aside the SEC's order approving IP's for trading on the securities exchanges.

Stock Index Futures Contracts

Stock index futures contracts extend the traditional futures contract functions—hedging and speculating—to an index of prices of publicly traded stocks. Stock index futures have the following basic characteristics:

1. The purchaser (long) and seller (short) enter into a contract based on the value of a stock index at a specified future date (the settlement or delivery date).
2. Neither the long nor the short owns the stock comprising the index.
3. The long or short may close out or cancel the stock index futures position on any trading day by an "offsetting" or "opposite" transaction with any other trader. The long would sell a sufficient number of futures to cover the contracts previously purchased, and conversely the short would purchase the same number of contracts previously sold.
4. Through these offsetting transactions, the long will profit from a rise in the index value compared to the initial contract price, and conversely the short will profit from a fall in the index value.
5. If the futures contract is not offset by the settlement or delivery date, the long or short will pay or receive the cash difference between the initial purchase price of the contract and the value of the contract on the last day of trading. (Physical delivery of the stocks in the index

> is prohibited under 7 U.S.C. § 2a(ii)(I).) Again, a long profits from an increase in the index value; a short profits from a decline in index value.[1]

Thus, as this Court noted in *Merrill Lynch, Pierce Fenner & Smith v. Curran*, 456 U.S. 353, 358 (1982), "[t]he purchase or sale of a futures contract on an exchange is . . . motivated by a single factor—the opportunity to make a profit (or to minimize the risk of loss) from a change in the market price."

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[1] *See* the discussion of stock index futures in Katzenbach, An Overview of Program Trading and Its Impact on Current Market Practices 6-9 (1987) ("Katzenbach Study"); Board of Governors of the Federal Reserve System, CFTC, and SEC, A Study of the Effects on the Economy of Trading in Futures and Options, Chap. II, pp. 1-33 (1984). The Katzenbach Study (pp. 7-8) gave examples of how stock index futures operate:

> The use of index futures is relatively simple. For example, the popular S&P 500 index future is a contract to buy or sell the value of the S&P 500 Index multiplied by $500. Thus, if the value of the S&P 500 Index were 245, one contract would be worth $122,500 (value of the index [245] multiplied by $500). The index futures contract specifies that settlement in cash must occur upon the termination of the contract, with the settlement being the difference between the contract price and the actual level of the stock index at the expiration of the contract. Thus, if an investor entered into a futures contract to buy a contract of the S&P 500 Index at a specified future date at 245, and the S&P 500 Index is 249 on that future date, the investor would gain $2,000 ($500 multiplied by the gain of 4). If the investor entered into a futures contract to sell an S&P 500 futures contract at the contract price of 245 and the S&P 500 Index is at 249 on that future date, the investor would lose $2,000 ($500 multiplied by a loss of 4).

Stock Index Participation Contracts

IP's have the following basic characteristics:

1. The purchaser (long) and seller (short) enter into a contract based on the value of a stock index at a specified future date (the cash-out date).
2. Neither the long nor the short owns the stocks comprising the index.
3. The long or short may close out or cancel their IP positions on any trading day by an "offsetting" or "opposite" transaction with any other trader. The long would sell a sufficient number of IP's to cover the contracts previously purchased, and conversely the short would purchase the same number of contracts previously sold.
4. Through these offsetting transactions, the long will profit from a rise in the index value compared to the initial contract price, and conversely the short will profit from a fall in the index value.
5. If the IP is not offset by the cash-out date and the long decides to end the agreement on the cash-out date, the long or short will pay or receive the cash difference between the initial purchase price of the IP and the value of the IP on the cash-out date. Again, a long profits from an increase in the index value; a short profits from a decline in the index value. If offset or cash-out does not occur by the end of each calendar quarter, then the IP long is credited and the IP short is debited for dividend equivalency payments resembling the dividends the IP long would have re-

> ceived had he owned the stock. This payment, of course, is reflected in the IP's market price.[2]

As with stock index futures, the purchase or sale of an IP is motivated by a single factor—to make a profit or minimize the risk of loss from a change in the market price.

REASONS FOR DENYING THE WRIT

I. THE SEVENTH CIRCUIT'S DECISION IS CORRECT.

The Court below correctly decided (1) that IP's are futures contracts under the CFTC's exclusive jurisdiction, and (2) that IP's are not stock index options within the SEC's jurisdiction.

A. IP's Are Futures Contracts.

In 1982, the SEC and CFTC agreed that the CFTC should have exclusive regulatory jurisdiction over stock index futures. To that end, the agencies jointly proposed, and Congress enacted, legislation which provides that:

> Notwithstanding any other provision of law— . . .
>
> (ii) This chapter shall apply to and the [CFTC] shall have exclusive jurisdiction with respect to . . . transactions involving, and may designate a board of trade as a contract market in, *contracts*

[2] Each of the petitioning exchanges added features to its own IP without changing the common economic essence. PHLX would permit cash-out at the end of each quarter without penalty and cash-out at 99.5% of the next day's closing index value at any other time. CBOE would allow semiannual cash-out by either the long or the short. AMEX would permit only quarterly cash-out but would provide the alternative of actual delivery of the underlying stock to settle the IP's, under restrictive conditions.

> *of sale . . . for future delivery of a group or index of securities (or any interest therein or based upon the value thereof). . . .* 7 U.S.C. § 2a, App. 116-117; emphasis added.

Thus, if IP's are stock index futures contracts, or contracts of sale for future delivery of the value of an index of securities, the SEC had no jurisdiction to approve IP's.

As the Court of Appeals ruled, IP's are futures contracts. Like other stock index futures, IP's are instruments that allow the parties to speculate on the future value of a group of stocks, without owning the stocks. App. 14-17. In assessing the common economic substance of futures and IP's, the Court of Appeals found:

> Shorts on IPs make the same pledge as shorts on stock-index futures contracts: to pay the value of an index on a prescribed day (the expiration date for the futures contract, the cash-out date for the IP). . . . Even from the long's point of view, IP and futures contracts ultimately look the same. The long pays up front for the IP, but the long on a futures contract *promises* up front to make a defined payment on the settlement date; the difference in the timing of the payment does not affect the fact that valuation comes at the defined future date. *Id.* at 16-17; emphasis in original.

The economic reality of IP's thus compelled the Court of Appeals to find IP's to be stock index futures.

The Court of Appeals focused on the economic substance of IP's in keeping with the interpretive principles set down by this Court in deciding what is a security. Under these principles, "we are not bound by legal formalisms, but instead take account of the economics of the transaction under investigation." *Reves v. Ernst & Young*, ____ U.S. ____, 110 S.Ct. 945, 949 (Feb. 21, 1990). The Court

of Appeals reasoned that "[i]f the interpretive approach is proper for the securities acts, it is no less proper for the futures acts." App. 23. Under these principles, the Court of Appeals disregarded form for substance in finding IP's to be futures and correctly rejected the SEC's formalistic approach to defining futures—an approach that would have created a serious regulatory gap under the Act. *Id.* at 24.

Unable to refute the Court of Appeals' conclusion that IP's are futures, petitioners first try to recast IP's and then misconstrue the Court of Appeals' decision. Contrary to petitioners' descriptions, IP's are not "market baskets of common stock" (AMEX Pet. at 13) or a "market basket security" (PHLX Pet. at 3). To reiterate what the Court of Appeals emphasized, "IP's are not stock *in* anything." App. 14; emphasis in original. IP purchasers do not own a market basket of stocks; indeed, as the Court of Appeals noted, unlike stocks "IP's don't carry votes because they don't have anything to do with equity." *Id.* at 15.

Petitioners also contend that under the Court of Appeals' holding any financial instrument for which value is "realized" (PHLX Pet. at 7) or "received" (AMEX Pet. at 20) at a future date has "futurity" and is therefore a futures contract. Based on this contention, petitioners argue that the decision below creates uncertainty over whether traditional securities including stocks and bonds as well as new types of securities are subject to SEC or CFTC jurisdiction. This uncertainty does not exist.

The Court of Appeals found an IP to be a futures contract because (1) an IP's value depended upon the ongoing market assessment of the value that the stock index would have on a "prescribed" or "defined" future date (App. 16-17) and (2) IP's do not convey an ownership interest in the stock in the index. *Id.* at 14-15. Far from the novel

pronouncement petitioners claim, the Court of Appeals' decision merely adopts the concept of futurity and the definition of a futures contract set forth in the only other appellate case addressing these issues, *CFTC v. Co Petro Marketing Group, Inc.*, 680 F. 2d 573 (9th Cir. 1982). Under this ruling, as the Court of Appeals explained, an instrument is a futures contract if its "value depended entirely on the price of the commodity at [its] expiration date, and [it was] not formed in contemplation of physical delivery." App. 21.

The focus of the Courts of Appeals on ownership or physical delivery in determining whether an instrument is a futures contract is grounded in the statute. Congress mandated under the Commodity Exchange Act that "future delivery" does "not include any sale of any cash commodity for deferred shipment or delivery." 7 U.S.C. § 2, App. 113. Under the law as applied by the Court of Appeals, therefore, the actual sale of a stock or bond cannot be for future delivery, notwithstanding petitioners' hyperbole to the contrary (PHLX Pet. at 8; AMEX Pet. at 20).

Application of the Court of Appeals' true principles to the parade of horribles portrayed by petitioners turns that parade into an apparition. Purchasers of stocks or bonds own the underlying securities; purchasers of stock index futures and IP's do not. Stock and bond purchasers also hope their investments will appreciate in value by an unspecified date in the future; longs and shorts in stock index futures or IP's are speculating that the value of a stock index will increase (or decrease) by a specified future date. Accordingly, under the Court of Appeals' decision, *when* a purchaser or seller of a futures contract receives value is meaningless. What counts is whether the instrument is structured to provide the market participants with an opportunity to speculate on or hedge

against price changes based upon the market's ongoing assessment of the instrument's value tied to a specified future date.[3]

In sum, petitioners fail to recognize the fundamental difference between changes in an asset's value over time and the "futurity" of a futures contract that ties the instrument's valuation to a specified future date. Therefore, petitioners' concern that the Court of Appeals has created a broad new definition of "futurity" is completely unfounded.

Petitioners also complain that IP's are not strictly "bilateral." (PHLX Pet. at 10-11; AMEX Pet. at 19.) The Court of Appeals correctly dismissed this contention (App. 21) because "bilateralism is not essential to a futures contract," citing *CFTC v. Co Petro Marketing Group, Inc.*, *supra.*

The asserted missing bilateralism stems from certain superficial payment differences in IP's and stock index futures. Upon entering into an IP, the long pays for the IP in full or pays in full a margin deposit equal to 50% of the IP's then current value. App. 81. Upon entering into a stock index futures contract, the long pays in full

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[3] This distinction between ongoing *valuation* tied to a future date and delayed *receipt* of value explains why PHLX's next-day cash-out alternative does not deprive IP's of futurity. PHLX allows an IP long to decide on one day to receive 99.5% of the IP's *next-day's* closing index value. Thus, when the long buys the IP and when he decides to cash out, he still cannot know what the IP's cash-out value will be.

Moreover, an IP's dividend equivalency payment does not distinguish an IP from a future. The value of the credit to the long or debit to the short for this pseudo-dividend is factored into the overall market value of an IP. Similarly, actual dividends declared and paid on the stocks in a stock index are taken into account by those trading the futures contract on that index.

the required margin deposit of approximately 10-15% of the then current value of the futures contract. As the Court of Appeals notes, this formalistic difference is meaningless because it "does not affect the fact that valuation comes at the defined future date." App. 17.

In other words, if an index futures long paid margin reflecting 50% or 100% of the then current value of the index, that would not transform the futures contract into a security.[4] The futures contract would remain a futures contract, regardless of the size of the margin payment, unless the long acquired the stock in the index upon entering into the contract and the contract's value was not tied to a defined future date. IP's do not have these characteristics. Thus, the Court of Appeals correctly found IP's to be futures.

B. IP's Are Not Options or Privileges.

AMEX (but not PHLX) has contended throughout that IP's are stock index options within the SEC's jurisdiction under 15 U.S.C. § 78i(g), App. 120. Options, however, have a settled business and legal definition: the buyer pays a "premium" to acquire the right, but not obligation, to buy the stock from the seller at the "strike" or "exercise" price. The instrument is termed an "option" because the buyer has the alternative not to consummate the purchase of the underlying stock if its market price falls below the "strike" price. An option is thus a limited risk investment because only the premium is lost if the option is not exercised. *See Deutschman v. Beneficial Corp.*, 841 F.2d 502, 504 (3d Cir. 1988), *cert. denied*, ____ U.S. ____, 109 S.

[4] Recently, the Commodity Exchange, Inc. called for 100% margin for its April copper futures contract. "Comex moves to avert squeeze on copper futures," *Financial Times*, p. 30, April 25, 1990. No one would seriously argue that 100% margin caused the copper futures contract to become a security.

Ct. 3176 (1989); *Laventhall v. Gen'l Dynamics Corp.*, 704 F.2d 407, 410-411 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983). AMEX attempted to force IP's into the option definition by labeling the *full* purchase price paid by the long as the "premium," thus making the "strike" or "exercise" price *zero*, and by arguing that the long had the "option" *never* to exercise it, thereby forfeiting the entire amount paid up front. However, the SEC did not find that IP's are options, App. 52 n. 57, and the Court of Appeals emphatically rejected the contention, *id.* at 18.

AMEX, the CBOE, and OCC (but again not PHLX) attempt to recycle the rejected "option" argument by using the word "privilege" instead, one of several option synonyms ("put," "call," and "straddle" are the others) appearing in both the futures and securities statutes. Petitioners contend that use by Congress of several different "option" terms "suggests" that each has different attributes. (AMEX Pet. at 23.) In fact, "privilege" traditionally has been used merely as a generic synonym for "option." *See, e.g.*, *Trusler v. Crooks*, 269 U.S. 475, 481 (1926).[5] Petitioners, indeed, make no showing that "privilege" means anything other than "option." Petitioners offer no case law, legislative history, or legal scholarship finding in the term "privilege" the broad meaning they would have this Court give it.

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[5] *See also* 80 CONG. REC. 8089 (1936) (remarks of Sen. Pope):

> Privileges, indemnities, bids, offers, puts, calls, etc.: These are true option contracts wherein, for a relatively small money consideration, the buyer of a privilege or indemnity obtains the right, during the next day (in the case of daily privileges) or during the next week (in the case of weekly privileges) to buy or sell, as the case may be, a stated amount of a given commodity for future delivery at a then stipulated price. A privilege contract giving the buyer the right to sell is called a "bid" or a "put," and the right given to buy is called an "offer" or a "call."

Moreover, petitioners' argument would sweep too broadly. If IP's are index "privileges," then stock index futures would also be "privileges" under SEC jurisdiction. Since the SEC and the CFTC jointly urged Congress to provide the CFTC exclusive jurisdiction over stock index futures, "privilege" cannot have the undefined breadth that petitioners imagine.

II. THE DECISION BELOW WILL NOT STIFLE INNOVATION.

Petitioners inaccurately claim that the Court of Appeals' decision is significant as a policy matter because it will stifle innovation in the securities markets. In the first place, IP's are not truly innovative. As demonstrated above, an IP is just a stock index futures contract wrapped in a different label. Moreover, the Court of Appeals' decision does not prevent IP's from being traded in the United States.[6] If PHLX and AMEX proposed to trade IP's on their affiliated futures exchanges and subject to CFTC jurisdiction, the CFTC has indicated publicly that it sees no impediment to expedited approval of IP's trading under the Commodity Exchange Act. 136 Cong. Rec. S1991 (daily ed. March 1, 1990) (reprinted speech by CFTC Chairman Wendy L. Gramm).

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[6] The IP's traded on the Toronto Stock Exchange, to which AMEX refers (AMEX Pet. at 15 n. 18), bear no resemblance to the IP's involved in this case. The Toronto IP~~'s~~ ("TIP's") are based on the Toronto 35 Index and constitute actual ownership units of a trust which in turn owns the stocks underlying the index. Actual dividends paid on the underlying stocks are accumulated by the trust and paid quarterly to the TIP owners. Owners of a sufficient volume of TIP's may redeem them for the underlying stocks at any time. *Investor's Daily*, March 19, 1990, at p. 11. These features were specifically introduced to distinguish TIP's from petitioners' IP's and ensure that TIP's are equity products and not futures. *Wall Street Letter*, August 7, 1989, at p. 8.

In the many months since the Court of Appeals' decision, PHLX and AMEX have not sought CFTC approval. Their failure to pursue IP's trading is explained by AMEX in two ways. First, since there is a larger group of registered securities salesmen than futures salesmen, the securities exchanges refuse to apply for CFTC approval of IP's. AMEX Pet. at 14. The size of the sales force, however, is not a principled basis for assigning regulatory jurisdiction. In any event, the CFTC has said it will consider cross-registering the securities salesmen under the Commodity Exchange Act for the purpose of trading IP's as futures. *See* 136 CONG. REC. at S1991. Second, many investors cannot by law or contract trade futures so IP's should not be considered futures. AMEX Pet. at 14. Disguising a futures contract as an IP in order to slip it by otherwise applicable legal restrictions is unsound policy at best, and no reason to narrow the definition of a futures contract.

The Court of Appeals properly refused to adopt these arguments:

> An instrument either is or is not a futures contract. If it is, the CFTC has jurisdiction; if it is not, the CFTC lacks jurisdiction; if the CFTC has jurisdiction, its power is exclusive. App. 21.

Similarly, the Court of Appeals refused:

> . . . to put a thumb on the scales, enlarging the category "securities" while shrinking the category "futures" because of the exclusivity clauses in the CEA: if both categories expand, then the SEC's jurisdiction shrinks. We do not conceive it our function, however, to invent counterweights to statutes; judges should be interpreters rather than sappers and miners. *Id.* at 24.

Finally, petitioners' concern that the Court of Appeals' decision is the death knell of new securities instruments

is belied by the New York Stock Exchange's new Exchange Stock Portfolio ("ESP"). The ESP is a true market basket since purchasers of the ESP own the stocks in the ESP basket.[7] Neither the CFTC nor respondents objected to the ESP because it is not a futures contract under the well-settled principles adopted by the Court of Appeals. Thus, the Seventh Circuit's decision has not stymied innovative securities instruments at all.[8]

III. CONGRESS IS CURRENTLY ADDRESSING THE JURISDICTIONAL ISSUE RAISED IN THIS CASE.

From the very creation of the CFTC, the securities industry has been fighting against CFTC control of futures contracts on financial instruments. Congress enacted the CFTC Act in 1974 and established broad CFTC jurisdiction over futures. The legislative history of the Act demonstrates that the CFTC was created "to fill all regulatory gaps—to regulate trading in futures and in options relating to commodities or commodity futures, because such trading is now poorly regulated if it is regulated at all." 120 CONG. REC. 34736 (1974) (Rep. Poage, Chairman of the House Agriculture Committee). Yet, in late 1974, when "the ink was barely dry" on the CFTC Act, the SEC proposed legislation that would have removed the CFTC's exclusive jurisdiction over futures, but Congress

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[7] *See* "NYSE Sets S&P 500 Product," *Chicago Tribune*, June 2, 1989, Sec. 3, p. 5.

[8] Moreover, as one commentator has recently noted, "handing futures regulation over to the SEC is no guarantee of innovation. The CFTC-regulated exchanges have been far more creative than the financial institutions regulated by the SEC." *Business Week*, April 16, 1990, at p. 100.

took no action. 2 Johnson & Hazen, Commodities Regulation § 437 (2d ed. 1989) at 267. In 1978 the SEC asked Congress to transfer all jurisdiction over financial futures from the CFTC to the SEC, but Congress again refused because it wanted to preserve the "economic expertise" of the CFTC over futures trading and avoid duplication of regulation over futures markets. *Id.* at 267-268; *see also* H.R. Rep. No. 1181, 95th Cong., 2d Sess. 13 (1978) (House Agr. Comm.); S. Rep. No. 95-850, 95th Cong. 2d Sess. 22-23 (1978) (Sen. Agr. Comm.).

This running dispute resulted in earlier jurisdictional litigation similar to this case. *See Chicago Board of Trade v. SEC*, 677 F. 2d 1137 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982). That case became moot with the enactment by Congress of the Johnson-Shad Accord legislation which preserved CFTC exclusive jurisdiction over financial futures and, specifically, stock index futures.

Congress now is considering a number of proposals to address the CFTC-SEC jurisdictional issues.[9] Congress gave the CFTC exclusive jurisdiction in order to oust the SEC from regulating stock index futures, like IP's. If Congress decides that policy decision was sound, Congress will not revise the statute. If Congress decides that policy decision was unsound, Congress can revise the statute as it has done in the past. This Court need not and should not.

[9] *See, e.g.*, 136 Cong. Rec. E988-989 (daily ed. April 4, 1990) (remarks of Rep. Eckart); 136 Cong. Rec. E983-985 (daily ed. April 4, 1990) (remarks of Rep. Glickman); 136 Cong. Rec. S3205-3206 (daily ed. March 26, 1990) (remarks of Sen. Dixon); and 135 Cong. Rec. S15379 (daily ed. November 9, 1989) (remarks of Sen. Gorton).

CONCLUSION

For the above reasons, the CME and Board of Trade ask the Court to deny the petitions.

Respectfully submitted,

MARK D. YOUNG
GARRETT B. JOHNSON
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5084

Counsel for Respondent Board of Trade of the City of Chicago

JERROLD E. SALZMAN
Counsel of Record
JAMES T. MALYSIAK
FREEMAN, FREEMAN & SALZMAN, P.C.
Suite 2700
401 North Michigan Avenue
Chicago, Illinois 60611
(312) 222-5100

Counsel for Respondent Chicago Mercantile Exchange

DATED: May 25, 1990

Nos. 89-1502, 89-1503 and 89-1484

In the Supreme Court of the United States

OCTOBER TERM, 1989

AMERICAN STOCK EXCHANGE, INC., ET AL., PETITIONERS

v.

CHICAGO MERCANTILE EXCHANGE, ET AL.

PHILADELPHIA STOCK EXCHANGE, INC., PETITIONER

v.

CHICAGO MERCANTILE EXCHANGE, ET AL.

INVESTMENT COMPANY INSTITUTE, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

KENNETH W. STARR
Solicitor General

JOHN G. ROBERTS, JR.
Deputy Solicitor General

MICHAEL R. DREEBEN
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTION PRESENTED

Whether financial instruments known as "index participations" are subject to the jurisdiction of the Securities and Exchange Commission, or, alternatively, are subject to the exclusive jurisdiction of the Commodity Futures Trading Commission as "involving contracts of sale of a commodity for future delivery" (7 U.S.C. 2).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-25)[1] is reported at 883 F.2d 537. An opinion denying the

[1] "Pet. App." refers to the appendix jointly filed by the petitioners in Nos. 89-1502 and 89-1503.

petitions for rehearing (Pet. App. 108-111) is reported at 883 F.2d 550. The orders of the Securities and Exchange Commission (Pet. App. 26-83, 84-107) are published at 54 Fed. Reg. 15,280 and 54 Fed. Reg. 15,575, respectively.

JURISDICTION

The judgment of the court of appeals was entered on August 18, 1989. The petitions for rehearing were denied on October 23, 1989. On January 12, 1990, Justice Stevens signed an order extending the time within which to file a petition for a writ of certiorari for the petitioners in No. 89-1502 to and including March 22, 1990, and the petition was filed on that date. On January 17, 1990, Justice Stevens signed an order extending the time within which to file a petition for a writ of certiorari for the petitioner in No. 89-1503 to and including March 26, 1990, and the petition was filed on that date. On January 19, 1990, Justice Stevens signed an order extending the time within which to file a petition for a writ of certiorari for the petitioner in No. 89-1484 to and including March 22, 1990, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case involves the interpretation of the statutes governing the jurisdiction of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Specifically, the question presented is which agency enjoys regulatory jurisdiction over recently invented financial products known as "index participations".

1. a. The SEC is, of course, charged with responsibility for regulating transactions in securities under the federal securities laws.[2] In the securities laws, Congress "enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an invest-

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[2] *E.g.*, the Securities Act of 1933, 15 U.S.C. 77a *et seq.*, and the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78a *et seq.*

ment." *Reves* v. *Ernst & Young*, 110 S. Ct. 945, 949 (1990). A security is defined to include, *inter alia*, "any * * * stock, * * * any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), * * * or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in * * * any of the foregoing [.]" 15 U.S.C. 78c(a)(10).

The CFTC was created in 1974 as an independent federal agency vested with the exclusive authority to regulate trading in futures contracts, a function that had long been carried out by the Department of Agriculture. Commodity Futures Trading Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389. Congress's purpose in amending the Commodity Exchange Act (CEA) to create the CFTC was to establish a "comprehensive regulatory structure to oversee the volatile and esoteric futures trading complex." H.R. Rep. No. 975, 93d Cong., 2d Sess. 1 (1974); *CFTC* v. *Schor*, 478 U.S. 833, 836 (1986). Under the CEA, the CFTC has "exclusive jurisdiction * * * with respect to * * * transactions involving contracts of sale of a commodity for future delivery." 7 U.S.C. 2.

b. In 1981, a disagreement arose between the CFTC and SEC over which agency had authority to regulate trading in a particular financial product. The SEC had approved trading on a securities exchange of standardized options on mortgage-backed debt securities guaranteed by the Government National Mortgage Association (GNMA). In a challenge brought by the Chicago Board of Trade, the Seventh Circuit set aside the SEC's orders on the ground that GNMA options involved futures contracts, the regulation of which was entrusted to the CFTC. See *Board of Trade* v. *SEC*, 677 F.2d 1137 (1982), vacated as moot, 459 U.S. 1026 (1982).[3]

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[3] The Solicitor General filed a petition for a writ of certiorari on the SEC's behalf in that case. *SEC* v. *Board of Trade of the City of Chicago, et al.*, No. 82-526. The enactment of legislation superseding the court of appeals' ruling rendered the case moot.

While the litigation was pending, the CFTC and SEC reached an agreement, known as the Shad-Johnson Accord, on how to divide their respective jurisdictions with respect to options on securities and certain other securities-derivative products. Congress subsequently enacted legislation that, in essence, implemented the agencies' agreement.[4] The legislation "clarified" that the SEC would regulate "options on all securities, and securities groups and indices," H.R. Rep. No. 626, 97th Cong., 2d Sess. Pt. 1, at 10-11 (1982), while the CFTC would regulate "futures contracts on broad based groups or indices of any securities as well as options on any such futures contracts." H.R. Rep. No. 626, *supra*, Pt. 2, at 2. See also S. Rep. No. 384, 97th Cong., 2d Sess. 21-24 (1982); H.R. Rep. No. 565, 97th Cong., 2d Sess. Pt. 1, at 38-40 (1982).[5]

2. In the late winter and spring of 1988, several stock exchanges sought the SEC's approval to list index participations for trading. In accordance with 15 U.S.C. 78s(b), the SEC published notice of the proposals in the Federal Register.

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and, accordingly, this Court vacated the judgment. 459 U.S. 1026 (1982).

[4] See Act of Oct. 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409 (amending the federal securities laws); Act of Jan. 11, 1983, Pub. L. No. 97-444, 96 Stat. 2294 (amending the Commodity Exchange Act).

[5] Pursuant to the Accord, the SEC was granted jurisdiction to regulate "the trading of any put, call, straddle, option, or privilege on any security * * * or group or index of securities (including any interest therein or based on the value thereof)," 15 U.S.C. 78i(g), while such jurisdiction was withheld from the CFTC. 7 U.S.C. 2a(i). The CFTC, in turn, was given "exclusive jurisdiction with respect to * * * transactions involving * * * contracts of sale * * * for future delivery of a group or index of securities (or any interest therein or based on the value thereof) [.]" 7 U.S.C. 2a(ii). Congress also conferred authority upon the SEC to disapprove applications to trade futures contracts based on the value of a group or index of securities (or options on such contracts) if the SEC determined that the statutory requirements for such contracts (or options) were not satisfied in a particular case. 7 U.S.C. 2a(iv)(II).

Index Participations (IPs) are standardized contracts based on the value of an index representing a portfolio of securities.[6] IPs do not represent ownership interests in an actual "market basket" of securities; rather, they provide vehicles for traders to experience gains or losses based on the performance of the underlying stock index (for example, the Standard & Poor's 500). The purchaser of an IP (the "long" or "holder") will profit from increases in the value of the index. The seller of an IP (the "short") will profit from a downturn in the index. With one exception, IPs do not involve any actual securities changing hands.[7] In addition, the shorts and longs do not deal directly with each other; after an IP contract is formed on an exchange, IPs are issued, cleared, and settled by a clearing corporation (here, the Options Clearing Corporation). IPs have no fixed expiration date; their existence is therefore—at least potentially—perpetual.

An IP holder acquires a contract by paying a market price that approximates the value of the index on the date of purchase, times a multiplier. The IP holder has two principal rights. First, the IP holder is entitled to "dividend-equivalent" payments approximating the cumulative dividends that would have accrued to a person owning a weighted basket of the securities in the index. Second, the IP holder may exercise the right to be paid the value of the index on a designated "cash out" date.[8]

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[6] The following description of IPs is based on the SEC's orders (Pet. App. 27-24, 84-98), and a disclosure document prepared under the auspices of the Options Clearing Corporation (OCC) to describe IPs to potential traders (C.A. App. 545-559).

[7] The American Stock Exchange, Inc. (Amex) IP gave the holder the right to take delivery of the index stocks under certain circumstances. See Pet. App. 28-29.

[8] The particular dates varied among the stock exchanges. The Philadelphia Stock Exchange, Inc. (Phlx) IP provided a 100% cash-out privilege quarterly and a cash-out privilege at all other times for 99.5% of the value of the index. The Amex IP provided a quarterly cash-out privilege. The Chicago Board of Options Exchange, Inc. (CBOE) IP provided a semi-annual cash-out privilege.

An IP short makes the reciprocal promise to pay the value of the index if and when an exercise notice is assigned to him on a cash-out date, and to pay the dividend equivalents. At any time, a long or short IP position can be liquidated, and profits or losses realized, by entering into the opposite type of transaction on the exchange (a "closing" or "offset" transaction).

In response to the SEC's notice regarding IPs, the CFTC and two futures exchanges filed comments urging that IPs were futures, and therefore not subject to SEC jurisdiction. The same comments also urged that IPs were not "securit[ies]" under the federal securities laws. Pet. App. 37-38. The Investment Company Institute (ICI) submitted comments arguing that IPs were governed by the Investment Company Act. *Id.* at 37.

On April 11, 1989, the SEC approved the proposals to trade IPs, concluding that: (a) IPs are "securities," Pet. App. 47-53; (b) IPs are not "futures contracts" within the exclusive jurisdiction of the CFTC, *id.* at 53-66; and (c) IPs are not subject to regulation under the Investment Company Act, *id.* at 66-67. The SEC also found that IPs would provide advantages to retail investors seeking to invest in "the market", and that the trading of IPs might reduce stock market volatility. *Id.* at 68 & n.97.

3. The futures exchanges filed petitions for review in the Seventh Circuit, which set aside the SEC's orders.[9] The court of appeals framed the issue as whether IPs are futures contracts; if so, under the applicable jurisdictional provision, 7 U.S.C. 2, the CFTC's jurisdiction was exclusive, even if the instruments were also securities under the federal securities laws. Pet. App. 14.

The court noted that from the perspective of the holder of an IP, the instrument resembles an interest in a portfolio of stock, except that an IP confers no voting rights. From the perspective of the short, however, the court found that an IP resembles a futures contract because the

[9] The CFTC filed a brief as amicus curiae, urging that IPs are futures contracts subject to its regulation.

short promises to make future delivery of the value of the underlying index. Pet. App. 14-16. Observing that neither the securities laws nor the CEA addressed such a product in a straightforward way, the court considered whether deference to the agencies' respective interpretations of their statutes was appropriate. Assuming without deciding that both the SEC and the CFTC were entitled to "some deference" in their competing claims to apply their statutes to IPs, the court concluded that "the IP is both a security and a futures contract." *Id.* at 20. The court explained that "[t]he only element of financial futures contracts that is missing is 'bilateralism,'" but that characteristic, the court stated, "is not essential to a futures contract." *Id.* at 21.[10] Applying the requirement in 7 U.S.C. 2 that the CFTC's jurisdiction is exclusive over products that are futures contracts, the court set aside the SEC's orders.[11]

ARGUMENT

The court of appeals held that an IP has attributes of both a security and a futures contract, and it ultimately concluded that under the regulatory schemes governing futures and securities, the CFTC has sole authority to regulate such instruments. Although the question decided by the court of appeals was a narrow one, its proper resolution is important to regulators, to the financial markets subject to their jurisdiction, and to the interpretation of the two statutory schemes in question. In the SEC's view, the court's holding is wrong and its under-

[10] By the term "bilateralism," the court referred to the characteristic of an instrument that creates future obligations on both sides. The court agreed with the SEC that "IPs are not bilateral because the long performs in full by paying up front[.]" Pet. App. 16.

[11] The court therefore did not reach the ICI's contention that IPs created arrangements subject to the Investment Company Act. Pet. App. 25. The court subsequently filed an opinion denying the stock exchanges and the SEC's petitions for rehearing, in which it rejected additional arguments, *id.* at 108-109; two judges voted to rehear the case en banc. *Id.* at 100-111.

lying analysis creates a climate of uncertainty about the proper boundaries between its jurisdiction and that of the CFTC; this, the SEC strongly believes, will harm financial innovation, capital markets, and investors. The SEC continues to subscribe to the views expressed in its orders and believes that, in light of the importance of the issues presented, review by this Court is warranted. In the opinion of the CFTC, the decision below is correct, does not announce principles that extend the CFTC's jurisdiction to areas entrusted to other regulators, and will not harm the operations of the Nation's financial markets.

While the SEC's views about its statute and the industry it regulates are entitled to weight, we cannot agree with the SEC that the decision below is incorrect, or that the analytical framework it employed departed from the intent of Congress in dividing authority between the SEC and CFTC. In our view, the court of appeals properly applied the CEA in finding that IPs are "contracts of sale of a commodity for future delivery" within the sole regulatory authority of the CFTC. That holding rests on a natural interpretation of the language of the CEA, and it fully accords with Congress's purposes in entrusting the exclusive regulation of futures contracts to a specialized agency. Moreover, we do not believe that the opinion augurs a wholesale expansion of CFTC jurisdiction at the expense of other agencies. The opinion itself suggests limiting principles, and other limiting principles are likely to be developed.

It is possible that the development of some new financial products will be "chilled" (as the SEC believes has already occurred) by the imprecision of the analysis governing whether a product is a futures contract, although hard evidence in support of that proposition is difficult to come by. At bottom, however, such consequences, to the extent they do exist, raise policy questions appropriate for Congress, rather than this Court, to address. While we fully agree that it would be desirable to have clear standards to apply in predicting which agency has jurisdiction to regulate a particular

product, the statutory schemes at issue are not susceptible to such "bright-line" tests. Not only is some imprecision inherent in the language chosen by Congress, the difficulty is compounded by the rapid development of new financial instruments not envisioned when Congress fashioned the securities and futures statutes. Because the court below properly resolved the problem at hand, and did so on the basis of correct legal principles, we believe that review by this Court is not warranted.

A. The central submission of the stock exchanges is that IPs are not properly characterized as futures contracts within the meaning of the CEA. The classification of IPs, as the court of appeals recognized, presents something of a conundrum; it requires applying the concepts expressed in each statute to a novel instrument possessing characteristics of both a security and a futures contract, although it is not a conventional version of either. On balance, however, we believe that the language and purposes of the CEA support the court of appeals' holding that IPs are futures contracts.

1. Futures contracts have traditionally been employed by buyers and sellers of commodities to shift the risks posed by fluctuations in price, and by speculators to assume those risks in the hope of earning a profit. See 7 U.S.C. 5 (setting forth legislative findings); H.R. Rep. No. 975, *supra*, at 33-35; S. Rep. No. 1131, 93d Cong., 2d Sess. 9-14 (1974); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353, 357-360 (1982) (describing background and purposes of futures contracts). Congress has long provided for the regulation of futures contracts because of their risk-shifting benefits and because of the danger that excessive speculation or manipulation of the futures markets could undermine their utility. 7 U.S.C. 5.

As a general matter, "the seller of the [futures] contract commits himself to deliver the commodity at a fixed date in the future, while the buyer commits himself then to accept delivery and pay the agreed upon price." *Leist* v. *Simplot*, 638 F.2d 283, 286 (2d Cir. 1980) (Friendly, J.), aff'd *sub nom. Merrill Lynch, Pierce, Fenner &*

Smith, Inc. v. *Curran, supra.* Futures contracts are usually formed without the expectation that the seller will make or the purchaser take actual delivery; they have standardized terms to facilitate their liquidation through offsetting transactions in a contract market; they involve the payment by both parties of "margin" deposits to secure future obligations; and they serve the primary purpose of shifting the risk of a change in the value of a cash commodity.[12] Those traditional elements must be applied, however, with sensitivity to the economic purposes of futures contracts as vehicles for hedging or speculating on price changes in the underlying cash market. As the CFTC and the courts have emphasized, "no bright-line definition or list of characterizing elements is determinative." *CFTC* v. *Co Petro Marketing Group, Inc.*, 680 F.2d 573, 581 (9th Cir. 1982); *In re Stovall*, [1977-1978 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,779 (1979) ("We do not mean that all commodity futures contracts must have all of these elements").

Against that background, the language of the CEA is properly interpreted to apply to IPs. Congress broadly vested the CFTC with "exclusive jurisdiction * * * with respect to * * * transactions involving contracts of sale of a commodity for future delivery[.]" 7 U.S.C. 2.[13] The term "future delivery" is expressly subject only to the limitation that it "shall not include any sale of any cash commodity for deferred shipment or delivery"; this provision was designed to exclude "forward contracts,"

[12] See *CFTC* v. *Co Petro Marketing Group, Inc.*, 680 F.2d 573, 579-580 (9th Cir. 1982); *In re Stovall*, [1977-1978 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,777 (1979); *Policy Statement Concerning Swap Transactions*, 54 Fed. Reg. 30,694, 30,694-30,695 (1989) (CFTC release); 1 P. Johnson & T. Hazen, *Commodities Regulation* § 103, at 10-11 (2d ed. 1989); Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 Vand. L. Rev. 1599, 1603 (1986).

[13] The term "contract of sale" is defined to include "sales, agreements of sale, and agreements to sell." 7 U.S.C. 2.

in which the parties contracting to sell a commodity actually expect to transfer the item, but, for reasons of convenience or necessity, postpone its delivery. 7 U.S.C. 2.[14] The term "commodity" is expansively defined to include "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. 2.

IPs are "contracts of sale"; they obligate the seller to "deliver" the value of a stock index on a future date; and the value of that index constitutes a "right" or "interest" under the CEA's definition of commodity. Moreover, there is no meaningful sense in which IPs can be considered forward contracts that are excluded from the CFTC's jurisdiction under 7 U.S.C. 2; the parties to an IP contract are not engaged in a commercial venture to buy and sell securities in the "cash" market, with delivery being deferred for reasons of convenience. Rather, the very purpose of the IP is to provide a way to earn profits (or limit losses) from changes in the value of the stock index, without owning the underlying shares. As such, IPs serve the quintessential function of futures contracts in transferring the risk of price change without transferring title to (or making delivery of) the underlying commodity.[15]

In its order, the SEC declared that IPs lack the "futurity" necessary to a futures contract because "an

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[14] See H.R. Rep. No. 975, *supra*, 129-130; *In re Stovall*, [1977-1978 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,777-23,778; 1 P. Johnson & T. Hazen, *Commodities Regulation* § 1.03, at 9-10 (2d ed. 1989). In contrast, in a futures contract, the typical expectation is that the contractual obligations will be extinguished by entry into an equal and opposite transaction on the exchange. *In re Stovall, supra.*

[15] IPs also have other features that support their treatment as futures contracts. They have standardized terms in order to facilitate trading. They are essentially instruments by which traders may hedge against, or speculate on, changes in the value of a commodity, namely, the value of the index. And the interests created in IPs can be extinguished (and their value realized) by offset transactions involving the purchase (or sale) of an equal and opposite contract.

IP contract represents the *present* obligation to pay or right to receive the *current* value of an underlying portfolio of securities." Pet. App. 55 (emphasis in original). However, it is undisputed that the IP holder has only the right to compel delivery of the value of the index on the cash-out dates. Those dates, as the court of appeals pointed out, "lie[] in the future to the same extent as the settlement date of any futures contract." *Id.* at 17.

The general purposes of the CEA are also served by applying its provisions to IPs. Cf. *Crandon* v. *United States*, 110 S. Ct. 997, 1001 (1990) (looking to "design of the statute as a whole and to its object and policy" in interpreting statutory language). One of the basic functions of futures markets is to permit owners of commodities to establish "hedges" against the risk of loss in the underlying "cash" market. See S. Rep. No. 1131, *supra*, at 11-15; 7 U.S.C. 5; *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. at 390. Congress recognized that purpose in providing for separate regulation of futures markets and cash markets, and it applied the principle of separate regulation specifically to trading in securities and futures contracts based on securities.[16]

As with other stock-index futures contracts, one function of IPs is to serve as hedges for a portfolio of stock: the contracts sold by the IP short increase in value when the net value of the securities in the underlying index declines. Consequently, the owner of securities (such as a portfolio manager of a pension fund) can seek to protect against falling prices in the securities markets by selling IPs. In designing its product, at least one stock exchange explicitly took account of the utility of selling

[16] In connection with the 1982 Accord legislation, the Agriculture Committees of both the House and the Senate noted that "the CFTC will continue to retain its traditional role of regulating markets and instruments that serve a hedging and price discovery function while the SEC will primarily regulate markets and instruments with an underlying investment purpose." H.R. Rep. No. 626, *supra*, Pt. 2, at 3; S. Rep. No. 384, 97th Cong., 2d Sess. 22 (1982) (same); see also H.R. Rep. No. 565, 97th Cong., 2d Sess. Pt. 1, at 40 (1982) (same).

IPs as a hedge. See Pet. App. 30 (describing operation of CBOE's cash-out privilege when exercised by a "hedged [IP] short"). Because IPs permit the same type of hedging activity that characterizes the use of other futures contracts, it is consistent with Congress's purposes to allocate jurisdiction over IPs to the CFTC.[17]

Of course, the general allocation of hedging instruments to the CFTC is qualified by the fact that the SEC has jurisdiction to regulate options on securities (and on indices of securities), which also can be used as hedging instruments. See 15 U.S.C. 78c(a)(10); 15 U.S.C. 78i; H.R. No. 626, *supra*, Pt. 1, at 5 & n.8; Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, and Securities and Exchange Commission, *A Study of the Effects on the Economy of Trading in Futures and Options*, 98th Cong., 2d Sess. 31-48 (Comm. Print 1985). But the point remains that it accords with Congress's purposes (as well as the literal text of the CEA) to construe the CEA to cover IPs. Congress elected to have the CFTC (not the SEC) be the primary regulator of "contracts of sale * * * for future delivery of a group or index of securities (or any interest therein or based upon the value thereof)." 7 U.S.C. 2a(ii). There is, therefore, no anomaly in holding that IPs, which fall within the statutory description of the CFTC's jurisdiction and can play the classic hedging role of a futures contract, should be regulated as futures.

2. Noting the differences between IPs and conventional futures contracts, petitioners contend (as did the SEC in its orders) that IPs are distinguishable from the instru-

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[17] The Amex asserted in the court below that IPs could not be used for hedging because the short must deposit 150% of the value of the contract upon its formation and thus must "commit *an even greater* amount of cash * * * for his 'insurance' than he paid for his cash product." Amex C.A. Reply Br. 10-11 (emphasis in original); see 89-1502 Pet. 14 n.16. That statement overlooks the fact that the short receives 100% of the value of the IP upon its sale; thus, the IP short is required only to add to that sum half of the value of his "cash product"—a commitment that is compatible with hedging.

ments traditionally subject to CFTC jurisdiction. The principal differences between IPs and traditional futures contracts are that (a) the long pays the entire purchase price when the contract is established (so that the contract is executory only for the short and is not "bilateral"); (b) the long is entitled to receive quarterly dividend-equivalent payments, and (c) the contracts do not have a fixed expiration date. Congress, however, did not specifically require any of these elements in order to have a futures contract.

In particular, Congress did not require "bilateralism," the feature on which petitioners lay the most emphasis. 89-1502 Pet. 19; 89-1503 Pet. 13. Had Congress desired a bilateralism requirement, it could easily have made the CFTC's jurisdiction applicable only to "contracts of sale * * * for future delivery *and payment*"; this would have required both the short and long to perform in the future, as petitioners would have it. But, of course, Congress did not include the italicized language in the statute. The statutory focus on futurity is solely on the short's obligation to make delivery. Nor did Congress express an intention to restrict the concept of a futures contract to its historical antecedents. Likewise, the CFTC—the agency charged with administering the CEA—does not require a fixed list of elements to trigger the statute's application, but looks to economic substance. *In re Stovall, supra.*

In the analogous area of the federal securities laws, the Court has refused to be "bound by legal formalisms, but instead take[s] account of the economics of the transaction under investigation." *Reves* v. *Ernst & Young*, 110 S. Ct. at 949; see *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967); *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943). A similar interpretive approach is warranted, and has been employed, in construing the CEA. See *CFTC* v. *Co Petro Marketing Group, Inc., supra.* Although the distinct features of IPs may, *to a holder*, make IPs resemble an interest in a portfolio of stock (or in a stock mutual fund), they do not alter the essential nature of the promise by the short. The fact remains that the IP

short agrees to deliver a commodity on a future date, and that is the key characteristic for coverage set forth in the CEA.[18]

In concluding that "bilateralism" was not essential in order to have a futures contract, the court of appeals relied on authority interpreting the CFTC's jurisdiction in the context of an enforcement proceeding, where a broad reading of the CEA serves to prevent harm to traders. Pet. App. 21, citing *CFTC* v. *Co Petro Marketing Group, Inc., supra.* Contrary to views expressed to us by the SEC, we believe that reliance on such authority was appropriate in the context of this case.[19] The difference between enforcement proceedings and authorization of trading in a

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[18] None of the other differences between IPs and traditional futures contracts seems particularly essential to the instrument's classification. For example, "margin" in the IP context is said to regulate credit (as in stocks); it reflects the long's ability to use borrowed funds for the transaction. In the futures context, margin serves as a good-faith guarantee of future performance. The role played by margin in an IP, however, may be more a function of the intent to trade IPs as securities rather than an inherent attribute of the product. In any event, the purpose of requiring the IP short to deposit margin is to secure its future performance —a purpose that is fully consistent with the analysis of an IP as a futures contract.

The Amex IP permitted the long in certain circumstances to take physical delivery of stock rather than receive a payment representing the value of the index. A futures contract based on the value of an index of securities must be settled in cash, rather than by transfer of the underlying securities. 7 U.S.C. 2a(ii)(I). Rather than suggesting that the Amex IP is not a futures contract, however, the physical delivery feature makes the Amex IP a type of stock-index future that Congress did not intend to authorize.

[19] In the SEC's view, the broad construction given to the concept of a futures contract in the law enforcement context should not be applied in this case, where such a construction will defeat the SEC's jurisdiction over a particular instrument that the SEC has authorized for trading; the SEC believes that the legislative history of the CEA and, in particular, the "SEC savings clause," see pp. 20-23, *infra,* counsel against the application of the CEA to infringe on SEC jurisdiction.

new product should not change the definition of a futures contract.

It is true that this Court has noted that the question whether a particular instrument is a security requires consideration of "the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole." *Marine Bank* v. *Weaver*, 455 U.S. 551, 560 n.11 (1982). That principle provides leeway for viewing an instrument to be a security in some, but not all, contexts.[20] The Court, however, has never embraced the principle that generalized notions of public policy could justify construing an agency's jurisdiction broadly in the enforcement context (in order to protect traders against fraud), yet narrowly in the regulatory context (in order to avoid suppression of a product that a sister agency believes would be useful and might not otherwise be brought to market). Such flexibility might advance what courts or agencies perceive to be good policy, but it would do so at the expense of Congress's chosen policy. Here, moreover, the treatment of the CFTC's jurisdiction in such a malleable fashion would effectively produce a zone of *concurrent* jurisdiction between the CFTC and SEC that Congress quite deliberately foreclosed (see pp. 21-22, *infra*).[21]

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[20] For example, *Marine Bank* held that certificates of deposits (CDs) insured by the FDIC were not "securities" on the facts before the Court. Subsequently, the Second Circuit held that a firm's program to obtain CDs for customers and to create a liquid market for their resale did create "securities" under the Exchange Act. *Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 240-242 (1985) (viewing the arrangement as an "investment contract").

[21] A consistent interpretation of the CEA is also needed to avoid incongruous results. For example, under the SEC's "contextual" approach, the CFTC might have had power to assert exclusive jurisdiction over IPs if the SEC had not authorized their trading, but, given that the SEC had done so, the CFTC was ousted from exercising jurisdiction. We agree with the court below that "[e]ither IPs are futures contracts or they aren't";

The Court has sometimes found that coverage under the federal securities laws was not required because another scheme of regulation amply protected the parties in a particular setting.[22] It could be argued here that the jurisdiction of the CFTC should yield because a fully adequate scheme of regulation is available under the federal securities laws. Congress itself, however, determined that when the CEA and the securities laws both apply, the CEA's jurisdiction prevails. There is, therefore, no latitude for the creation of a new, non-statutory exemption from the CEA. See H.R. Conf. Rep. No. 1383, 93d Cong., 2d Sess. 35 (1974) (the CFTC's "jurisdiction over futures contract markets or other exchanges is exclusive" and "where applicable, supersedes State as well as Federal agencies").

Nor do we believe that the court of appeals erred in applying principles of deference to the agencies' interpretations of their statutes. In concluding that the CFTC had jurisdiction over IPs, the court of appeals assumed, without deciding, that both agencies were owed deference in construing their respective statutes to apply to IPs. Pet. App. 18-20. Under *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), an agency's reasonable interpretation of its governing statute is entitled to deference in areas where the statute is silent or ambiguous. We see no reason not to apply that principle to the statutory provisions here.[23] The SEC argued

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that determination cannot depend on which agency acts first in asserting jurisdiction. Pet. App. 22.

[22] See *Marine Bank*, 455 U.S. at 558 (certificate of deposit was not a security in part because of the scheme for regulation of that instrument under federal banking laws); *Teamsters* v. *Daniel*, 439 U.S. 551 (1979) (noncontributory, compulsory pension plan was not a security in part because of the scheme for regulation of the plan under ERISA).

[23] Principles of deference apply even though the issue of interpretation affects an agency's jurisdiction. See *CFTC* v. *Schor*, 478 U.S. 833, 845 (1986); cf. *Dole* v. *United Steelworkers*, 110 S. Ct. 929, 944 (1990) (White, J., dissenting) (citing cases); *Missis-*

in its rehearing petition, however, that the court's deference to the CFTC in this particular case was flawed because the court only accepted the CFTC's conclusion, while rejecting its rationale. SEC C.A. Reh'g Pet. 10-11, citing *SEC* v. *Chenery Corp.*, 318 U.S. 80 (1943). In particular, the SEC noted that the CFTC had urged that "bilateralism" was essential to find a futures contract, and, although the court of appeals agreed with the SEC that IPs lack bilateralism, Pet. App. 16, the court nonetheless purported to defer to the CFTC's bottom line that IPs were futures.

There are indeed passages in the CFTC's amicus curiae submissions to the court of appeals that, fairly read, characterize bilateralism as an essential aspect of a futures contract. CFTC C.A. Br. 8 (generally, in a futures contract "both parties to the contract are obligated to fulfill the terms of the contract at a specified price."); *id.* at 10 ("Besides futurity, IPs possess a second essential element of a futures contract: both parties to an IP are obligated to fulfill the contract at the specified price even though the contracts may be satisfied either by delivery or offset."). But clouding the issue is the fact that the CFTC found the element of "bilateralism" satisfied in this particular case. *Ibid.* The CFTC's understanding of that term, therefore, may not be wholly shared by the SEC and the court of appeals.

More fundamentally, this Court need not exercise its certiorari jurisdiction to decide whether the CFTC's process of reasoning was accurately understood by the court below. The CFTC did express the opinion that IPs are subject to its jurisdiction, and the language and purposes

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sippi Power & Light Co. v. *Mississippi ex rel. Moore*, 487 U.S. 354, 377 (1988) (Scalia, J., concurring). Here, of course, the jurisdiction of each agency depended on the characterization of an IP under the applicable statutes; the SEC asserted jurisdiction by interpreting the securities laws to apply to IPs, while the CFTC claimed jurisdiction by interpreting the CEA to apply to IPs. Under 7 U.S.C. 2, in such a case, the CFTC's jurisdiction prevails (provided the CFTC's interpretation is reasonable and consistent with its statute).

of the statute are consistent with that view. Moreover, other sources of the CFTC's thinking support the position that each element of a classic futures contract need not be present to invoke its jurisdiction; the touchstone is the economic purpose and overall nature of the instrument. See *CFTC* v. *Co Petro Marketing Group, Inc., supra*; *In re Stovall, supra*. Accordingly, since the court of appeals correctly interpreted the CFTC's broader conclusions in this area, we do not believe that review of the issue of deference is necessary here.

The stock exchanges press the argument (89-1502 Pet. 19; 89-1503 Pet. 10) that "bilateralism" must be held essential to a futures contract in order to prevent the CEA's jurisdiction from sweeping in a host of other instruments whose value is realized in the future. For example, petitioners Amex, CBOE, and OCC claim that "options" cannot be distinguished from futures contracts absent bilateralism (89-1502 Pet. 19); petitioner Phlx makes the same claim about transactions in stock (89-1503 Pet. 10). Quite apart from the absence of a "bilateralism" requirement in the text of the statute, however, these arguments are unpersuasive.

Bilateralism is not the main distinction between options and futures. It is well recognized that the long in an option pays only a premium for the right to buy or sell the underlying interest; his exposure is accordingly limited to that sum. See N. Katzenbach, *An Overview of Program Trading and Its Impact on Current Market Practices* 7 (1987) ("The purchaser of the option, however, cannot suffer unlimited losses caused by movements in market price."). In contrast, the long in a futures contract has far greater exposure to loss resulting from price changes.[24]

[24] Petitioners claim (89-1502 Pet. 18-20) that the court of appeals' analysis leaves no distinction between futures and options, but their method of reaching that conclusion is flawed. Petitioners isolate particular distinctions the court drew one-by-one, and claim that each is inadequate. Read as a whole, however, the court offered a concept of options as a distinct product offering "a careful balance among premium, strike price, and duration." Pet. App. 18.

As to the supposed need for bilateralism to distinguish stock transactions from futures transactions, it is sufficient to note that the seller and purchaser of stock in an ordinary exchange transaction intend to transfer the instrument, without any future contractual obligations. Economically, the sale of stock is purely a "cash" transaction; the typical five business days allowed for settlement does not detract from that characterization.[25] There is, therefore, no necessity to engraft a strict bilateralism requirement to distinguish the body of transactions traditionally covered by the securities laws from the type of instrument Congress intended to be regulated as a futures contract.[26]

2. In an effort to limit the coverage of the CEA, petitioners and the SEC have cited the provision in 7 U.S.C. 2 known as the "SEC savings clause." 89-1502 Pet. 21-22; 89-1503 Pet. 12 n.11; SEC C.A. Reh'g Pet. 5-8. That provision does not, in our view, justify limiting the CFTC's jurisdiction over IPs. The SEC savings clause appears immediately after the grant of exclusive jurisdiction to the CFTC over "contracts of sale * * * for future delivery" and states:

> *And provided further*, That, except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission

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[25] Cf. Op. CFTC Gen. Coun., No. 85-2 [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673, at 30,856 (1985) (two business day settlement period "for purposes of administrative convenience or necessity" did not convert a precious metals transaction into a futures contract, on the particular facts).

[26] Petitioners point (89-1502 Pet. 20) to a variety of more complex transactions (such as "European-style options," "zero-coupon bonds," "index warrants," and "variable annuities") as examples of instruments that are claimed to exhibit the same degree of futurity as IPs, and whose classification is therefore called into question by the court of appeals' opinion. Those instruments were not involved in this case (or discussed by the court even in dicta), and review is not warranted to discuss abstract principles that might or might not apply to them in some other case.

> or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws.

7 U.S.C. 2. The text of this provision sets forth no explicit substantive limitations on the CFTC's jurisdiction. Rather, its operative effect is expressly confined to provisions other than the CFTC's jurisdiction-granting language, which immediately precedes it. See Pet. App. 109.

Moreover, the legislative history of the SEC savings clause [27] does not indicate that the CFTC's jurisdiction over futures contracts should be read narrowly as applied to novel or unconventional products—which IPs surely are. That history reveals that Congress was particularly concerned with protecting the SEC's jurisdiction in its *traditional* areas of regulation. The history does not support the view that the concept of a "futures contract" should be given a narrow reading as applied to hitherto unknown financial products.

The original House bill provided both that the CFTC was to have exclusive jurisdiction over futures contracts and that nothing in the bill was to supersede the SEC's jurisdiction. H.R. 13113, 93d Cong., 2d Sess. § 201(B) (1974); H.R. Rep. No. 975, *supra*, at 3 (noting that SEC jurisdiction would be preserved "in those areas *traditionally* regulated by it") (emphasis added). The genesis of this provision was that prior to the 1974 amendments, regulation of trading in futures contracts was limited to specified agricultural commodities. The 1974 amendments proposed to expand the definition of "commodity" to cover any interest in which futures contracts were traded. To respond to the fact that "the expanded definition of 'commodity' * * * may include rights and interests which are

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[27] See generally Johnson, *The Commodity Futures Trading Commission Act: Preemption as Public Policy*, 29 Vand. L. Rev. 1, 7-19 (1976); Greenstone, *The CFTC and Government Reorganization: Preserving Regulatory Independence*, 33 Bus. Law. 163, 205-208 (1977).

securities as defined in the federal securities laws," the House Report explained that "except in the area of transactions involving a contract market, the jurisdiction of the [CFTC] is intended to exist *concurrently* with the jurisdiction vested in the [SEC]." *Id.* at 28 (emphasis added).

The Senate, however, rejected the notion of concurrent jurisdiction set forth in the House bill. In its Report, the Senate Committee indicated that it desired to give the CFTC *exclusive* jurisdiction "with regard to the trading of futures on organized contract markets," without "infring[ing] on the jurisdiction of the [SEC] or other government agencies." S. Rep. No. 1131, *supra*, at 23. Accordingly, the Senate added a new preface to the savings clause: "'[E]xcept as hereinabove provided,' nothing contained [in the section] shall supersede or limit the jurisdiction at any time conferred on the [SEC]." *Id.* at 31. The Report explained that the purpose of this amendment was to "clarif[y]" that the CFTC's "jurisdiction over futures contracts markets or other exchanges is exclusive," such that the CFTC's "jurisdiction, where applicable, supersedes State as well as Federal agencies." *Id.* at 6, 23. That language removed any overlapping jurisdiction between the CFTC and the SEC.

The Senate version on this point prevailed in conference. See H.R. Conf. Rep. No. 1383, *supra*, at 35-36 ("Under the exclusive grant of jurisdiction to the Commission, the authority in the Commodity Exchange Act (and the regulations issued by the Commission) would preempt the field insofar as futures regulation is concerned"). The purpose of the SEC savings clause was to clarify that the broadened definition of commodity "was not intended * * * to apply to trading in interests and rights traditionally known as securities, including, for example, stocks, corporate bonds, warrants, and debentures," but that the CFTC was authorized to exercise exclusive regulatory jurisdiction over the futures markets. 120 Cong. Rec. 34,737 (1974) (remarks of Rep. Poage); *id.* at 34,997 (remarks of Sen. Talmadge).

Interpreted in light of its history, the savings clause does not provide a basis for narrowing the CFTC's jurisdiction over novel instruments that fall outside of "traditional" SEC and CFTC domains. Congress did, of course, express an intention not to infringe on the SEC's jurisdiction over instruments it traditionally regulated. Indeed, the court of appeals recognized a similar principle. Pet. App. 14 ("if IPs are really 'stock,' they almost certainly are not 'futures contracts' "). But no such principle applies to IPs. Although the SEC's order reasoned that IPs are "stock" based on the analysis in *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681 (1985), see Pet. App. 49-50, the court of appeals strongly suggested that IPs cannot be viewed as stock because they lack an issuing entity in which the holder owns an equity interest. *Id.* at 14-15. Although other terms in the statutory definition of "security" may very well apply to IPs, we share the court's doubts that IPs can be fit within the definition of "stock." [28] In any event, there is no evidence that "synthetic" securities such as IPs are what Congress had in mind when it drafted the SEC savings clause.[29] The savings clause is simply silent on the proper classification of such an instrument. To the extent that the IP is a novel instrument qualifying as both a "futures contract" and as a "security," the jurisdictional provisions call for exclusive regulation by the CFTC.

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[28] The Court in *Landreth* was concerned with describing the characteristics of "common stock" as found in an instrument that bears the name "stock." 471 U.S. at 681; *id.* at 688 (describing the instruments before it as "traditional stock"); see also *Reves* v. *Ernst & Young*, 110 S. Ct. at 950 ("common stock is the quintessence of a security"). IPs, of course, are not called "stock" and cannot be viewed as interests in a business enterprise in the sense that common stock is such an interest.

[29] Indeed, Congress has, since the 1974 amendments, rejected proposals by the SEC to remove futures trading in indexes of securities from the exclusive authority of the CFTC. See S. Rep. No. 850, 95th Cong., 2d Sess. 21-23 (1978) (accompanying CFTC reauthorization bill); *id.* at 22 (noting that Congress had recognized in 1974 that "futures markets would not remain static," and

3. Petitioners Amex, CBOE, and OCC contend (89-1502 Pet. 22-24) that the court of appeals erred in failing to hold that the SEC has jurisdiction over IPs pursuant to 15 U.S.C. 78i(g), which provides that "[n]otwithstanding any other provision of law, the [SEC] shall have the authority to regulate the trading of any put, call, straddle, option, or privilege of any * * * group or index of securities (including any interest therein or based on the value thereof)." Review of that question is not warranted because the SEC itself did not rely on 15 U.S.C. 78i(g) in its order permitting the trading of IPs. See *SEC* v. *Chenery Corp.*, 318 U.S. at 92-95.

The SEC canvassed a number of bases in 15 U.S.C. 78c(a)(10) in determining that IPs were "securities." The SEC found that IPs were "stock"; "certificate[s] of interest or participation in" stock; and "instrument[s] commonly known as a security." Pet. App. 47-53. The SEC also alluded to the possibility of analyzing IPs as receipts for interests in securities, or as investment contracts, which are also enumerated types of securities in the statutory definition. *Id.* at 48 n.47. In passing, the SEC stated that IPs had some characteristics that resemble features of "rights to purchase or puts or calls on a security or index of securities," but concluded that "IPs predominantly have the attributes of a portfolio of common stock." *Id.* at 52.[30] In the face of this survey, the lack of any plain statement that IPs might fall within 15 U.S.C. 78i(g) is a conspicuous omission. Indeed, the SEC did not rely on Section 78i(g) in its opening brief

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stating that "the basic conclusion reached in 1974 that there should be a single regulatory agency responsible for futures trading is as valid now as it was then"). Again, in 1983 when Congress enacted legislation to implement the SEC-CFTC jurisdictional accord, it confirmed that the CFTC had exclusive jurisdiction over futures contracts based on the value of an index of securities. 7 U.S.C. 2a(ii).

[30] The only option-like characteristics to which the SEC pointed were the cash-out and physical-delivery features of IPs. Pet. App. 52.

in the court of appeals. Not until its reply brief did the SEC inform the court that it accepted petitioners' view that Section 78i(g) applied; even then, the SEC qualified its position by stating "that the cash-out privilege in every IP (as distinguished from the IP itself) is an 'option or privilege' on an index, placing the IP within the statutory jurisdiction of the SEC." SEC C.A. Reply Br. 10-11.

Although the SEC is not foreclosed from considering the application of Section 78i(g) to IPs, this Court should not review that issue on the present record. The Court has frequently admonished that "Congress has delegated to the administrative official and not to appellate counsel the responsibility for elaborating and enforcing statutory commands." *Investment Company Institute* v. *Camp*, 401 U.S. 617, 628 (1971); *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 137, 143 (1984 ("*post hoc* rationalizations by counsel for agency action are entitled to little deference"). Here, the SEC did not explicate the relationship of 15 U.S.C. 78i(g) to IPs in its administrative order or indicate that it based its action on that provision; consequently, this Court does not have the benefit of the considered analysis of the issue by the responsible agency.[31] Because the SEC should address the ramifications of applying Section 78i(g) to IPs in the first instance, review should not be granted to address that issue.[32]

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[31] The court of appeals (properly) did not decide the question either. The court indicated that "IPs convey privileges based on the value of an index" and thus the "closest match" in the definition of a security to an IP may be the language added in the Accord, Pet. App. 15, but it also expressed the view that IPs are not "options," *id.* 17-18.

[32] We note, without expressing a view on the matter, that applying Section 78i(g) to IPs raises questions that underscore the desirability of prior SEC consideration. Section 78i(g) was added to the securities laws to confirm the SEC's jurisdiction over stock index options. See H.R. Rep. No. 626, *supra*, Pt. 1, at 9, 12. It is unclear whether the word "privilege" in that section was intended to encompass a different type of interest from an "option,"

B. Petitioners contend that this Court's review is needed to alleviate the "quandary" facing participants in the financial markets regarding which system of regulation—that of the CFTC or SEC—will apply to innovative new products. 89-1502 Pet. 15; 89-1503 Pet. 6-7. In petitioners' view, the court of appeals' decision is so open-ended that it creates confusion over the tests for identifying a futures contract. This uncertainty, it is feared, will inhibit the development, approval, and marketing of new products in the Nation's financial sector. *Ibid.* Petitioners raise a concern—shared by the SEC—that such regulatory obstacles will impede the Nation's financial markets in international competition.[33] Although we do

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such as the IP holder's cash-out privilege. That interpretation would give to the term "privilege" a quite distinct connotation from the other terms listed in the section, a "put," "call," "straddle", or "option." Cf. *Dole* v. *United Steelworkers*, 110 S. Ct. 929, 935 (1990) ("The traditional canon of construction, *noscitur a sociis*, dictates that 'words grouped in a list should be given related meaning.'"). Furthermore, if the IP holder has a "privilege" on the index because of the cash-out feature, perhaps the same could be said of the long in a stock index futures contract; but that conclusion would conflict with the distinction between futures and options intended by Congress. Before these issues are addressed by this Court or any other, the SEC should be given a chance to articulate its views and explain the reasons supporting the application of Section 78i(g) to IPs.

[33] For example, petitioners state (89-1502 Pet. 15 n.18) that IPs are being traded on the Toronto Stock Exchange. (We understand that the Canadian product, the Toronto 35 Index Participations Units (TIPs), consists of units of a trust created by a stock exchange that holds, as underlying assets, the securities in the index. As such, these "units" are quite different from the contracts formed by the purchase and sale of IPs.) Reports have also circulated that a product bearing similarities to IPs will be offered in the United Kingdom. See *Citibank Plans UK Cash Basket Products*, Financial Times, Dec. 14, 1989.

We note, however, that the holding here allocating jurisdiction over IPs to the CFTC did not doom that product not to be traded; the CFTC proposed to cooperate with the SEC in authorizing the trading of IPs as futures contracts. See Statement of Dr. Wendy L. Gramm, Chairman, CFTC, Before the Securities

not minimize the importance of maintaining regulatory clarity, or the detrimental consequences that may flow from regulatory confusion, we do not believe that those problems can effectively be addressed by this Court's review of the question presented in this case.

To begin with, the Seventh Circuit's opinion need not be read, as petitioners fear, as a harbinger that the CFTC has jurisdiction to regulate any product with "an element of futurity," regardless of all other factors. 89-1503 Pet. 6; *id.* at 7 (finding flaws in the opinion when read with "the broadest possible scope"). The methodology of the court of appeals suggests otherwise. The court compared the particular characteristics of IPs to the recognized paradigms of futures contracts and securities; it acknowledged that IPs did not fit squarely within either model; but it ultimately found that IPs had every element of a financial futures contract save for "bilateralism." Pet. App. 21. Although the court refused to give the CEA a cramped reading that would effectively freeze the CFTC's jurisdiction to products known in 1974, the court did note that there are direct, substantial limitations on the concept of a futures contract. For example, the court made clear that products that are genuinely "stock" cannot be futures, Pet. App. 14, nor are products that are "options," *id.* at 18.

The court of appeals did not, of course, write a treatise to govern the categorization of all financial instruments, and some new hybrid or synthetic products will inevitably pose difficult problems of classification. But there is no reason to interpret the court's opinion as putting in doubt the settled regulatory treatment of a host of distinct financial products that were not at issue in that case.[34] In any event, petitioners' proposed limiting princi-

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Subcomm. of the Senate Comm. on Banking, Housing, and Urban Affairs 28-29 (Mar. 29, 1990) (describing proposals to authorize trading in IPs by cross-registration of securities account executives and futures associated persons).

[34] Indeed, the court was careful to reserve the question whether "an IP with a daily cash-out feature at no penalty" was a futures

ple—that the CFTC's jurisdiction should be defined principally by reference to "the types of futures contracts described in the legislative history that accompanied the enactment of the exclusive jurisdiction clause," 89-1502 Pet. 22—finds no support in the language or policies of the CEA, and would open the statute to ready evasion.

In the current, dynamic financial environment, the goal of achieving legal clarity, which petitioners—and the SEC—understandably desire, may prove elusive. Justice Holmes' admonition that "[c]ertainty generally is illusion, and repose is not the destiny of man" rings true in this area. Holmes, *The Path of the Law,* 10 Harv. L. Rev. 461, 466 (1897). "The boundaries of financial markets, from the demarcation between banking and investing to the presumably slighter distinction between any two given instruments, defy precise delineation." N. Katzenbach, *supra,* at 3. Indeed, prior to the decision in this case, commentators noted the difficulty in drawing lines between the CFTC and SEC's authority in view of the proliferation of new and complex financial instruments.[35] To the extent that such ambiguities are inherent in the statutes, however, predictable tests are likely to be achieved only through development of the case law, the issuance of administrative regulations, or congressional action. Earlier this Term the Court remarked, in explicating the meaning of the term "note" under the federal securities laws, that "[o]ne could question whether, at the expense of the goal of clarity, Congress overvalued the goal of avoiding manipulation by the clever and dishonest. If Congress erred, however, it is for that body, and not this Court, to correct its mistake." *Reves* v.

contract. Pet. App. 110. That reservation demonstrates not the "illogic" of the court's position (see 89-1503 Pet. 9), but its restraint. The reservation of the proper legal status of a product with such a minute difference from the IPs before the court underscores the limited nature of the court's holding.

[35] See Gilberg, *supra,* 39 Vand. L. Rev. at 1686 (noting the "definitional ambiguities in the law" and pointing out that the "question of which of the two agencies has jurisdiction over a specific product is very often itself unclear").

Ernst & Young, 110 S. Ct. at 950 n.2. A similar point well applies, in our view, to the statutory concept of a futures contract.[36]

Recognizing the potential for uncertainty, the CFTC has sought to provide detailed guidance to the financial community with respect to the scope of its jurisdiction in certain areas. See *Regulation of Hybrid Instruments*, 54 Fed. Reg. 1128 (1989) (proposed rules); 54 Fed. Reg. 30,684 (1989) (final rules); *Policy Statement Concerning Swap Transactions*, 54 Fed. Reg. 30,694 (1989); *Statutory Interpretation Concerning Certain Hybrid In-*

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[36] Congressional committees are currently exploring the policy issues raised by the allocation of jurisdiction between the CFTC and the SEC, including issues raised by this case. Hearings were held before the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs on March 29, 1990, the House Committee on Agriculture on May 8, 1990, and the Telecommunications and Finance Subcommittee of the House Committee on Energy and Commerce on May 24, 1990. At those hearings, the Chairmen of the SEC, CFTC, and the Federal Reserve Board, as well as the Under Secretary of the Treasury for Finance, testified regarding the broader issues stemming from the division of authority between the CFTC and SEC, and the narrower issue whether the regulation of stock index futures should be transferred from the CFTC to the SEC. Under Secretary Robert R. Glauber stated in his May 8, 1990, statement to the Senate Agriculture Committee (at p. 10) that "[r]egulatory competition also begets jurisdictional squabbles, which can strangle innovation. New products are not merely stifled; they quickly move to overseas markets."

Several bills are pending in Congress that deal with these issues. See H.R. 3662, 101st Cong., 2d Sess. (1989) (intended to transfer jurisdiction over stock index futures to the SEC); H.R. 4477 (intended to consolidate regulation of securities and futures in a single agency); S. 2335 (intended to require appointment of one SEC commissioner to CFTC and one CFTC commissioner to SEC) (both in 101st Cong., 2d Sess. (1990)). The issue is receiving high-level attention under the aegis of the President's Working Group on Financial Markets, consisting of representatives of the SEC, CFTC, Federal Reserve Board, and the Treasury Department. On May 8, 1990, the Secretary of the Treasury advised the Senate Agriculture Committee of the Administration's support for a bill that would, among other things, shift regulatory authority for stock index futures to the SEC and modify the CEA's "exclusivity" clause.

struments, 55 Fed. Reg. 13,582 (1990) (regarding instruments that combine characteristics of futures contracts or commodity options with debt or certain equity interests). The issuance of these statements reflected the CFTC's recognition that "the proliferation of hybrid instruments incorporating futures or commodity option elements in innovative formats has caused uncertainty as to the regulatory status of such instruments." The rules proposed by the CFTC were thus intended "to ensure that existing regulatory structure[s] do not unnecessarily retard growth or innovation or fail to provide protections that are responsive to market developments." 54 Fed. Reg. 1128 (1989). Although the CFTC's statements do not purport to address all interpretive questions under the CEA, they diminish somewhat the need for the judiciary to take on the unaccustomed role of furnishing comprehensive answers in this area.

In sum, the proper interpretation of the CFTC's jurisdiction is an important question that this Court has not had an occasion to address.[37] We believe, however, that the question was answered correctly below. The many issues that lie beyond the periphery of this case do not require this Court's present attention.[38]

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[37] Indeed, the courts of appeals have had comparatively few opportunities to interpret the CEA in this context. See 89-1502 Pet. 11 (characterizing issues presented as "a matter of first impression"). For IPs, however, the court of appeals' decision is in effect a national precedent; the reversal of the SEC's order precludes the further marketing of the product as a security. We note that this aspect of the SEC/CFTC controversy may give the Seventh Circuit a disproportionate influence over the development of this field of law. For historic reasons, Chicago is home to many of the nation's futures exchanges, and those parties can therefore bring their challenges to SEC orders in the Seventh Circuit, as they did here. See 15 U.S.C. 78y. Circuit conflicts may accordingly be slow to develop.

[38] As to the ICI's "conditional" petition for certiorari, we believe that the Court should deny it as well. If the Court grants the petitions for certiorari in Nos. 89-1502 and 89-1503, the ICI petition should be held for disposition in light of those cases. The court of appeals never addressed the question whether IPs are governed by the Investment Company Act, and this Court would be benefitted by the airing of those issues in that court as an initial matter.

CONCLUSION

The petitions for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

JOHN G. ROBERTS, JR.
Deputy Solicitor General

MICHAEL R. DREEBEN
Assistant to the Solicitor General

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Nos. 89-1502, 89-1503

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

No. 89-1502

AMERICAN STOCK EXCHANGE, INC., ET AL.,
Petitioners,
v.
CHICAGO MERCANTILE EXCHANGE, ET AL.,
Respondents.

No. 89-1503

PHILADELPHIA STOCK EXCHANGE, INC.,
Petitioner,
v.
CHICAGO MERCANTILE EXCHANGE, ET AL.,
Respondents.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

JOINT REPLY OF PETITIONERS TO BRIEFS IN OPPOSITION

BURTON R. RISSMAN,
Counsel of Record
ROGER PASCAL
ROBERT B. FOSTER
Schiff Hardin & Waite
7200 Sears Tower
Chicago, Illinois 60606
(312) 876-1000
Attorneys for The Options Clearing Corporation

Of Counsel

DON L. HORWITZ
General Counsel
The Options Clearing Corporation

MAHLON M. FRANKHAUSER
Lord Day & Lord, Barrett Smith
1201 Pennsylvania Ave., N.W.
Suite 821
Washington, D.C. 20004
(202) 393-5024
Attorney for American Stock Exchange, Inc.

NANCY R. CROSSMAN
Chicago Board Options Exchange, Incorporated
LaSalle at Van Buren
Chicago, Illinois 60605
(312) 786-5600
Attorney for Chicago Board Options Exchange, Incorporated

EARL H. NEMSER
H. PETER HAVELES, JR.
RALPH BERMAN
Cadwalader, Wickersham & Taft
100 Maiden Lane
New York, New York 10038
(212) 504-6000
Attorneys for Philadelphia Stock Exchange, Inc.

Attorneys for Petitioners

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ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

JOINT REPLY OF PETITIONERS TO BRIEFS IN OPPOSITION

The petitioners in No. 89-1502, American Stock Exchange, Inc., Chicago Board Options Exchange, Incorporated and The Options Clearing Corporation, and the petitioner in No. 89-1503, Philadelphia Stock Exchange, Inc., submit this joint reply to the briefs in opposition filed by the Solicitor General "for the federal respondent" ("S.G. Br.") and by respondents Chicago Mercantile Exchange and Board of Trade of the City of Chicago ("CME/CBT Br.").[1]

ARGUMENT

A. The brief in opposition filed by the Solicitor General shows that the issues presented by this case loom large in the administration of two federal regulatory schemes. The brief states that the proper resolution of these issues "is important to regulators, to the financial markets subject to their jurisdiction, and to the interpretation of the two statutory schemes in question." (S.G. Br. 7.) It notes that, in the view of the SEC[2]—the agency of the United States which is the federal respondent in this case[3]—the holding of the court of appeals "is wrong and its underlying analysis creates a climate of uncertainty about the proper boundaries between [the SEC's] jurisdiction and that of the CFTC" and that this "will harm financial innovation, capital markets, and investors." (*Id.* 7–8.) The brief further notes that the SEC shares the petitioners' concern that the confusion and uncertainty created by the court of appeals' decision "will inhibit the development, approval, and marketing of new products in the Nation's financial sector" and that this "will impede the Nation's financial markets in international competition." (*Id.* 26.) The brief makes clear that the issues involved are sufficiently important to receive "high-level attention under the aegis of the President's Working Group on Financial Markets," as well as the attention of a number of Congressional committees, and it notes that the Adminis-

[1] The lists included at p. ii of the petitions for a writ of certiorari in Nos. 89-1502 and 89-1503 pursuant to Rule 29.1 of the Rules of this Court remain currently accurate.

[2] The abbreviations used in this reply brief are the same as those used in the petition in No. 89-1502.

[3] The brief is captioned "Brief for the Federal Respondent in Opposition," even though the SEC is the only federal respondent, the brief is not signed by any of the SEC's attorneys, and it is plain on the face of the brief that the SEC believes that certiorari should be granted. (S.G. Br. 8.)

tration believes that jurisdictional squabbles of the kind involved in this case " 'can strangle innovation. New products are not merely stifled; they quickly move to overseas markets.' " (*Id.* 29, n.36, quoting the statement of Robert R. Glauber, Under Secretary of the Treasury for Finance, before the Senate Agriculture Committee on May 8, 1990.) Finally, it states in summation that "the proper interpretation of the CFTC's jurisdiction is an important question that this Court has not had an occasion to address." (S.G. Br. 30.)

The Administration and the SEC also have stressed the importance of the issues presented here in their testimony before Congress. For example, in his May 8, 1990 statement to the Senate Agriculture Committee, Under Secretary Glauber, expressing the Administration's views, noted that the result of the court's current interpretation "has been protracted litigation over what constitutes a 'future'; an inability to trade in the U.S. markets most suited to the product; and the shifting of business to more hospitable overseas markets. This is precisely what happened to Index Participation Certificates, which now trade in Toronto rather than the United States." (Statement of Robert R. Glauber, Under Secretary of the Treasury for Finance, before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry, May 8, 1990, at 10.) Similarly, in recent Congressional testimony, Chairman Breeden testified that as a result of the court of appeals' decision "it is most unlikely that any U.S. securities exchange will trade, or any corporate issuer will issue, any new security that may even be argued to include any element of a futures contract" and that the decision "could do incalculable damage to the U.S. securities markets." (Testimony of Richard C. Breeden, Chairman of the SEC, before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, March 29, 1990, at 7.) It is thus plain that the questions presented are viewed by the Administration and the SEC as being of great importance to the regulation, competitiveness and development of the Nation's markets.[4] The Solicitor General's brief does not basically disagree with these conclusions.

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[4] On June 5, 1990, the Department of the Treasury transmitted the Administration's legislative proposal to Congress. The proposal con-

(Footnote continued on following page)

B. Under the statutory scheme governing the regulatory authority of the SEC and the CFTC, the SEC (and not the CFTC) has been given jurisdiction "to regulate the trading of any put, call, straddle, option or privilege on any . . . group or index of securities (including any interest therein or based on the value thereof)," and the CFTC (and not the SEC) has been given jurisdiction with respect to "transactions involving . . . contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the value thereof)." Section 9(g) of the Exchange Act, 15 U.S.C. § 78i(g); Sections 2(a)(1)(B)(i) and (ii) of the CEA, 7 U.S.C. §§ 2a(i) and (ii). Further, if a transaction involves a "security" but not a futures contract, then it is subject to the regulatory jurisdiction of the SEC under the securities laws. The word "security" is a defined term in the Exchange Act and the other federal securities laws, and it has also been the subject of considerable interpretation by this Court. *See, e.g., Reves v. Ernst & Young,* 110 S.Ct. 945, 948–52 (1990); *Marine Bank v. Weaver,* 455 U.S. 551, 555–56 (1982); *Tcherepnin v. Knight,* 389 U.S. 332, 335–40 (1967). On the other hand, the other terms used as the basis for allocating regulatory jurisdiction—"option," "privilege," and "contracts of sale for future delivery"—have no statutory definition, and their meanings have never been decided or settled by this Court.

1. The definition of "contracts of sale for future delivery" (or "futures contracts") has proved to be an elusive one. The court of appeals decision and the Solicitor General's brief in this case are breaking new ground when they reject bilateralism as an essential element of a futures contract. The CFTC's brief before the court of appeals refers to bilateral obligations as an

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[4] *continued*

tains a provision that is intended by the Administration to overrule the court of appeals' decision in this case because the "result of this decision . . . has been to impede the development of innovative financial instruments that may have some aspect of futurity." (*See* Letter from Jeanne S. Archibald, Acting General Counsel of the Department of the Treasury, to Dan Quayle, June 5, 1990, enclosing Section-by-Section Analysis of proposed legislation, at 10.)

"essential element of a futures contract." (CFTC App. Br. 10; S.G. Br. 18.) Similarly, when the Solicitor General petitioned for a writ for certiorari on behalf of the SEC in *SEC v. Board of Trade of the City of Chicago, et al.*, No. 82-526, he stated:

> Unlike an option, a futures contract is an executory sales contract, involving a promise to deliver and a promise to take delivery and make payment at some time after the contract is formed.

(S.G. Pet. in No. 82-526, at 18, n.18.) This definition—which includes bilateral obligations of both buyer and seller—conforms with those supplied by commentators. *See, e.g.*, Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 Vand. L. Rev. 1599, 1603 (1986); 1 P. Johnson & T. Hazen, *Commodities Regulation*, § 103, p. 10 (2d ed. 1989). Thus, both the court of appeals' decision and Solicitor General's brief reject earlier views as to how to define a futures contract. They both give great deference to the conclusions of the CFTC (but not the reasoning) that IPs are futures contracts (App. 22-24; S.G. Br. 17-18), but they provide little guidance as to why one instrument should be deemed to be a "futures contract" and another not.

2. The case of *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573 (9th Cir. 1982), was cited by the court of appeals as authority for its finding that bilateralism was not an essential element of a futures contract (App. 21), and this citation is supported by the briefs in opposition. (S.G. Br. 15; CME/CBT Br. 11-12.)[5] However, the contracts in *Co Petro* were in fact bilateral, as both parties were obligated to perform at a specified future date even though the buyer's financial obligation was limited by a liquidated damages clause. *Co Petro*, 680 F.2d at 576. It is therefore inaccurate to speak of *Co Petro* as authority for the elimination of bilateralism as an essential element of a futures contract.

[5] The *Co Petro* decision, which respondent futures exchanges note is the *only* other appellate case addressing these issues (CME/CBT Br. 12), was rendered by a divided court. The dissenting judge stated: "There is an indication that Congress intended . . . to regulate the sale of 'futures' *as that term is used in the trading markets of the nation*." *Co Petro*, 680 F.2d at 587 (Smith, J., dissenting; emphasis supplied).

Clearly, the CFTC did not think of *Co Petro* as such authority when it filed its brief with the court of appeals.

3. In concluding that IPs are futures contracts, the Solicitor General's brief places significant emphasis on the conclusions that a function of the futures markets is to permit hedging and that one function of IPs is to serve as a hedge. (S.G. Br. 12-13.) There are two deficiencies with this argument. First, the SEC never found that IPs would function as hedging instruments.[6] Instead, it found that IPs had the economic characteristics of other securities and that IPs would provide retail investors with a means "to invest in 'the market.' "[7] (App. 47-53, 69.) Accordingly, the Solicitor General is supplying a finding that the SEC did not make.[8] Second, as the Solicitor General recognizes (S.G. Br. 13), securities options can and are used as hedging instruments. In addition, other types of securities—*e.g.*, warrants and convertible stocks and bonds—can also be used as hedging instruments. Thus, even if IPs could be used secondarily for hedging purposes, this would not serve as a principled basis for treating them as futures contracts for jurisdictional purposes.

4. The Solicitor General's reading of the legislative history is flawed. (S.G. Br. 20-23.) The brief quotes a Congressional statement that SEC jurisdiction would be preserved "in those areas traditionally regulated by it" (S.G. Br. 21) and concludes that only traditional securities, such as stocks, remain free from the jurisdictional inroads of the CFTC. Apart from the fact that this conclusion ignores other relevant statements by Congress,[9] it reads what Congress said too narrowly. IPs were designed to be marketed, traded on national securities exchanges and cleared

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[6] *See* petition in No. 89-1502, at 14, n.16.

[7] That was essentially the reason why the Investment Company Institute argued that IPs are investment company shares. (App. 37.)

[8] The Solicitor General reached his conclusion based on a belief by CBOE that a feature of its form of IP would assist shorts who wished to hedge. (S.G. Br. 12-13; App. 30.) However, this feature was not included in the IPs traded on AMEX and PHLX and therefore cannot properly be used as a general basis for allocating jurisdiction.

[9] For example, the petition in No. 89-1502 noted that Congress had described the exclusive jurisdiction clause as applying to the trading of

(Footnote continued on following page)

like options and other securities, and it was certainly within the SEC's "traditional area of regulation" to regulate the trading of those instruments in the same manner that it regulated other securities. (Pet. in No. 89-1502, at 5-6.) That the SEC was acting in its traditional area of regulation was emphasized by the Chairman of the SEC, in a letter to Congress explaining why the SEC did not agree with a compromise suggested by the CFTC to consider cross-registration of securities brokers under CFTC rules if IPs were traded on futures exchanges. Among other things, the Chairman said that:

> the Commission believes that the securities regulatory system, which has a primary emphasis on retail investor protection, is ideally suited for IPs. In approving IPs, the Commission concluded that IPs might be of substantial interest, not only to institutional investors, but also to retail investors as a lower cost means of obtaining the economic equivalent of an investment in a portfolio of stock. In part because of the expected retail interest in the product, the Commission concluded that the regulatory protections for retail investors in place for the securities markets should be applied to IPs.

(Letter from David S. Ruder, Chairman of the SEC, to Senators Patrick Leahy and Richard Lugar, May 22, 1989, at 2–3; footnotes omitted.) On the other hand, IPs were not designed to be marketed, traded or cleared in the manner traditionally applicable to futures contracts, and petitioners believe that IPs could not be successfully marketed and traded in such manner.[10]

The Solicitor General misunderstands Congress' use of the word "traditionally." Congress said "*areas* traditionally regulated by it," but the Solicitor General shifts this to "*instruments* it

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[9] *continued*

"futures on organized contract markets," and that it had said that, with that exception, it did not wish to infringe on the jurisdiction of the SEC. (Pet. 16.)

[10] *See* Statement of Wayne P. Luthringshausen, Chairman of the Board of OCC, before the Subcommittee on Telecommunications and Finance of the House of Representatives Committee on Energy and Commerce, May 24, 1990, at 9–10; Testimony of James R. Jones, Chairman, AMEX, before the House Subcommittee on Telecommunications and Finance, May 24, 1990, at 9–10.

traditionally regulated." (S.G. Br. 21–23; emphasis supplied.) There is nothing in the legislative history to suggest that Congress intended to freeze the SEC's jurisdiction to the group of instruments that were regulated by it prior to 1974 or that the SEC was not to be the federal regulator of new forms of investment. On the other hand, there is nothing in the court of appeals decision or in the CFTC's release to suggest that "traditional" securities having an element of "futurity" may not be held to be subject to the CFTC's exclusive jurisdiction.[11] As is shown by a recent release relating to hybrid instruments, the CFTC believes that its jurisdiction could extend to certain bonds, preferred stocks and equities. *Regulation of Hybrid Instruments,* 54 Fed. Reg. 30684, 30684–85 (1989).

5. As discussed in the petition in No. 89-1503, the court of appeals determined that the CIP possessed "futurity" despite the fact that the CIP gave an investor the right to realize the value of his investment on a *daily* basis. (Pet. 9–11). The court noted that the daily cash-out provided for the payment of 99.5% of the value of the underlying index, rather than 100%, and reserved decision on an instrument providing for 100% cash-out. (App. 27–28.) The Solicitor General argues that the court's reservation on an instrument that differs to only a "minute" degree evidences the "limited nature of the court's holding." (S.G. Br. 27–28, n. 34.) However, neither the court nor the Solicitor General offers a reasoned basis for distinguishing between two fundamentally identical instruments that differ only by 0.5% of economic value. Instead of illustrating that the holding was limited, the court of appeals' treatment of the daily cash-out illustrates the confusion its decision engenders.

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[11] The Solicitor General's brief implies that the TIPs being traded on the Toronto Stock Exchange may not be futures contracts because they are backed by units of trust that hold the securities in the index. (S.G. Br. 26, n.33.) It is hard to see how this would make a difference under the Solicitor General's "key characteristic" test (S.G. Br. 14–15), since the short is required to deliver at a future date whether or not the underlying securities are held in trust. Thus, rather than clarifying matters, the Solicitor General's test has extended the reach of the definition of "futures contract" to embrace such traditional investment company securities as units of trust.

6. Petitioners in No. 89-1502 argued that one of the important jurisdictional provisions adopted by Congress in 1982—Section 9(g) of the Exchange Act, 15 U.S.C. §78i(g), which vested the SEC with jurisdiction to regulate the trading of any "privilege on any . . . group or index of securities (including any interest therein or based on the value thereof)"—was not considered by the court of appeals even though the court had noted that "IPs convey privileges based on the value of an index." (Pet. 22–24.) The Solicitor General does not comment on the merits of this argument; instead he contends, citing *SEC v. Chenery Corp.*, 318 U.S. 80, 92–95 (1943), that review of the question is not warranted because the SEC did not rely in its order on Section 9(g).[12] (S.G. Br. 24–25.)

Chenery involved a "determination of policy or judgment which the agency alone is authorized to make and which it has not made" and not a determination of jurisdiction. 318 U.S. at 88. When it next took up the Chenery matter, the Court said:

> a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis. To do so would propel the court into the domain which Congress has set aside exclusively for the administrative agency.

SEC v. Chenery Corp., 332 U.S. 194, 196 (1947). Certainly, a determination as to whether an agency has jurisdiction is not a determination that "an administrative agency alone is authorized to make." The *Chenery* principle does not apply to determinations by an agency of its own jurisdiction, and an agency does not lose jurisdiction conferred by statute by failing to assert all of the bases for exercising it.[13]

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[12] However, as the petition in No. 89-1502 notes (Pet. 23, n.32), the analysis in the SEC's order is not inconsistent with reliance on Section 9(g).

[13] In this case, the CFTC stated that it had jurisdiction for reasons that were not accepted by the court of appeals. The court of appeals and the

(Footnote continued on following page)

Further, even if the *Chenery* doctrine were applicable to agency determinations of jurisdiction, the court of appeals should have remanded the proceeding to the SEC for its determination as to the applicability of Section 9(g). *See, e.g., FTC v. Sperry and Hutchinson Co.,* 455 U.S. 233, 249–50 (1972) (modified court of appeals' reversal of agency order to require a remand to the agency for its determination whether to apply the alternate rationale offered in support of its order). It would therefore be appropriate, if the Court did not wish to decide this issue on the merits at this stage, for the Court to grant certiorari and to modify the court of appeals reversal so as to require a remand to the SEC on this issue.[14]

7. The respondent futures exchanges argue that IPs are not options or privileges. (CME/CBT Br. 14–16.) In doing so, they rely on a 1926 case and a 1936 remark of a Senator to provide a definition of a word used by Congress in a 1982 enactment designed to make it certain that the SEC would have jurisdiction to regulate transactions in "any" option or privilege. The futures exchanges thus want to have it both ways: they want "futures contract" to be defined in a way that has no relationship to any traditional use of the term and to be expandable as the need arises,[15] and, at the same time, they want to limit the definitions of "option" and "privilege," as used to fix the jurisdiction of the SEC, to 50-year old usages in the commodity markets. Clearly, Congress intended a more evenhanded treatment. The question as to how these jurisdictional words should be defined remains an open one that, we believe, is important for this Court to examine.

[13] *continued*
Solicitor General are prepared to accept the CFTC's bottom-line conclusion, but not its reasoning, notwithstanding *Chenery.* There is no reason to apply a different standard to the bottom-line conclusion of the SEC.

[14] The Solicitor General says that the SEC is not foreclosed from considering the application of Section 9(g) to IPs. (S.G. Br. 25.) However, in the absence of a remand, it is difficult to see how it would be possible for the SEC to open up this issue.

[15] The futures exchanges argue that the court of appeals found IPs to be futures contracts because "(1) an IP's value depended upon the on-

(Footnote continued on following page)

C. The respondents argue that this Court should leave it to Congress to correct any mistaken holding by the court of appeals. (S.G. Br. 28–29; CME/CBT Br. 18–19.) However, the pendency or possibility of a legislative solution should not deter the Court from granting certiorari. In the absence of legislative action, the agencies and the public must look to the courts for final resolution of conflicting statutory interpretations of existing laws. If the Congress should enact legislation overruling the decision of the court of appeals, the Court will be able to vacate the judgment as moot. If, on the other hand, Congress does not act, it remains important for this Court to settle the important jurisdictional questions involved.

CONCLUSION

The petitions for a writ of certiorari in Nos. 89-1502 and 89-1503 should be granted.

Respectfully submitted,

EARL H. NEMSER
H. PETER HAVELES, JR.
RALPH BERMAN
Cadwalader, Wickersham & Taft
100 Maiden Lane
New York, New York 10038
(212) 504-6000
Attorneys for Philadelphia Stock Exchange, Inc.

BURTON R. RISSMAN,
Counsel of Record
ROGER PASCAL
ROBERT B. FOSTER
Schiff Hardin & Waite
7200 Sears Tower
Chicago, Illinois 60606
(312) 876-1000
Attorneys for The Options Clearing Corporation

[15] *continued*
going market assessment of the value that the stock index would have on a 'prescribed' or 'defined' future date . . . and (2) IP's do not convey an ownership interest in the stock in the index." (CME/CBT Br. 11.) This not only departs from the reasons advanced by the Solicitor General (S.G. Br. 14–15), but it also ignores that the value of virtually all securities (other than common stocks, which, like IPs, have a perpetual existence) depends on assessments of value of the underlying assets or obligations at a prescribed future date, and that Congress adopted Section 9(g) and amended Sections 3(a)(10) and 28(a) of the Exchange Act to allow for securities which are based on the value of an underlying index and which do not convey an ownership interest in the securities in the index. *See* H.R. Rep. No. 626, 97th Cong., 2d Sess., pt. 1 at 9, *reprinted in* 1982 U.S. Code Cong. & Admin. News 2780, 2787.

NANCY R. CROSSMAN
Chicago Board Options
Exchange, Incorporated
LaSalle At Van Buren
Chicago, Illinois 60605
(312) 786-5600
Attorney for Chicago Board Options Exchange, Incorporated

Of Counsel:

DON L. HORWITZ
General Counsel
The Options Clearing Corporation

MAHLON M. FRANKHAUSER
Lord Day & Lord,
Barrett Smith
1201 Pennsylvania Avenue, N.W.
Suite 821
Washington, D.C. 20024
(202) 393-5024
Attorney for American Stock Exchange, Inc.

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